78-606
78-607

Nos. 78- and 78-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, ET AL.,
Respondents.

GENERAL TELEPHONE COMPANY OF CALIFORNIA,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, ET AL.,
Respondents.

JOINT APPENDIX FOR PETITIONERS

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APPENDIX A

APPENDIX A

Order Denying Alternative Writ
S. F. No. 23746

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA
IN BANK

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, ETC.,
Petitioner

v.

PUBLIC UTILITIES COMMISSION, ETC., ET AL., *Respondents.*

(FILED JULY 13, 1978)

Petition for writ of Review DENIED.

Richardson, J., is of the opinion that the petition should be granted.

Motion for leave to intervene is dismissed as moot.

/s/ BIRD
Chief Justice

Order Denying Alternative Writ
S. F. No. 23743

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA
IN BANK

GENERAL TELEPHONE COMPANY OF CALIFORNIA, ETC.
Petitioner,

v.

PUBLIC UTILITIES COMMISSION, ETC., ET AL., *Respondents*

Petition for writ of Review DENIED.

Richard, J., is of the opinion that the petition should be granted.

Motion for leave to intervene is dismissed as moot.

/s/ BIRD
Chief Justice

APPENDIX B

APPENDIX B

Decision No. 87838

September 13, 1977

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application No. 53587

(Filed September 19, 1972)

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 51774

(Filed March 17, 1970)

In the matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.

Application No. 55214

(Filed September 30, 1974;
amended December 13, 1974)

In the Matter of the Application of The Pacific Telephone and Telegraph Company, a corporation, for telephone service rate increases to offset increased wage, salary and associated expenses.

Case No. 9503

(Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, prac-

tices, contracts, service and facilities of The Pacific Telephone and Telegraph Company.

Case No. 9802

(Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of the Pacific Telephone and Telegraph Company.

Case No. 9832

(Filed November 26, 1974)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.

Application No. 51904

(Filed May 15, 1970;
amended July 17, 1970)

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.

Application No. 53935

(Filed March 28, 1973)

In the Matter of the Application of General Telephone Company of California, a corporation, for authority to increase its rates and charges for telephone service.

Case No. 9100

(Filed August 4, 1970)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of General Telephone Company of California.

Case No. 9504

(Filed January 30, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, separations, practices, contracts, service and facilities of the telephone operations of all the telephone corporations listed in Appendix A, attached hereto.

Case No. 9578

(Filed July 3, 1973)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, practices, contracts, service, and facilities of GENERAL TELEPHONE COMPANY OF CALIFORNIA, a California corporation; and of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.

(Appearances are listed in Appendix A.)

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Opinion

This is the latest, and hopefully the final, proceeding on the long and tortuous road involving the regulatory rate treatment of accelerated tax depreciation (which includes asset depreciation range, class life system, salvage value, and repair allowance) and the Job Development Investment Credit, now called the Investment Tax Credit (ITC), for two major California telephone utilities, The Pacific Telephone and Telegraph Company (Pacific), and General Telephone Company of California (General). This proceeding results directly from the remand by the California Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted Pacific in D.83162 dated July 23, 1974 which related to accelerated tax depreciation and ITC. (All other matters decided in D.83162 were affirmed by the court). This annulment also applied to General because in D.83778 dated November 26, 1974 General's accelerated tax depreciation and ITC were treated by this Commission in the same manner as was Pacific's in D. 83162.

At the time the above decision was filed by the court, there was under submission another rate increase proceeding for Pacific, A.55214, in which we issued D.85287 on December 30, 1975. D.85287 granted a rate increase subject to refund to provide for any adjustment in the rates that might be required as a result of the hearings in the instant proceeding. In addition, at the time this matter was remanded by the court two rate increase applications, A.55492 for Pacific and A.55383 for General, were pending. The accelerated depreciation and ITC issues in those pro-

ceedings were removed for final determination in this proceeding.

In the remanded matters this Commission had set rates based on the normalization method of accounting,[1] which involves the computation of rates based on the same method of depreciation, both for depreciation expense and federal income tax expense, while the federal income taxes are actually paid on the basis of a different amount of (accelerated) depreciation expense. Since accelerated depreciation substantially increases the allowable expenses to the utility, the taxable income, and therefore the federal income tax expense of the utility, is substantially below what it would have been had taxes been paid on the ratemaking (straight-line) depreciation basis. The difference between the amount of taxes computed on a straight-line depreciation basis and an accelerated depreciation basis is reflected in a reserve account called the deferred tax reserve. This amount, on an average basis, is deducted from rate base so that the authorized rate of return is not earned on this sum. The deferred tax reserve accumulates from year to year disproportionately to revenues, expenses, and

[1] Internal Revenue Code (IRC) Section 167(*l*)(3)(G), which reads as follows:

"(G) Normalization method of accounting.—In order to use normalization method of accounting with respect to any public utility property——

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

rate base as long as the overall plant additions by the utility continue to grow. To this extent, the taxes set aside in the deferred tax reserve shall never be paid and amount to an actual tax saving, rather than only a deferral. (ITC is defined as a tax credit, thus is a direct tax saving and not a deferral.)

In the remand of D.83162 the Supreme Court held, inter alia, that this Commission has the power to implement an alternative method, e.g., an annual adjustment, of tax expense treatment for accelerated depreciation and ITC. This annual adjustment method was discussed but not used in arriving at the treatment set forth in D. 83162. The Supreme Court ordered this Commission to give consideration to this method, as well as other alternatives, including the possibility of a commensurate adjustment in the rate of return, and to provide for refunds, if appropriate.

Hearings on this remand were held between March 1, 1976 and July 9, 1976 before Commissioner Robert Batinovich and Examiner Philip E. Blecher. The matter was submitted on the latter date subject to the filing of briefs.

The Proposed Report of the examiner was issued on January 19, 1977. Exceptions to the Proposed Report were timely filed by Pacific, General, City of Los Angeles (LA), and Toward Utility Rate Normalization (TURN). These exceptions shall be discussed where appropriate.[2]

Review

D.83162, 83778, and 85287 have exhaustively reviewed and discussed this tax expense issue from its inception. We shall not reiterate that discussion, but shall attempt to confine the review of evidence and discussion of the issues to those old matters still pertinent here, as well as the new matters not previously raised. However, we think a

[2] All transcript corrections requested after the date of submission by Pacific, General, and LA have been adopted.

brief recounting of three California Supreme Court decisions relating to this issue is warranted.

Case 1: City and Council of San Francisco v. Public Utilities Commission, et al. (1971) 6 C 3d 119. This case annulled D.77984, which had provided that Pacific could use accelerated depreciation with the normalization method of accounting as defined in IRC Section 167, because this Commission failed to consider lawful alternatives in the calculation of federal income tax expense. On page 130 the court said: "Because these methods involve fictitious allowances for tax expense and because they provide results which in the light of current federal income tax law are either harsh on the utility or the ratepayers, the Commission may also consider alternative approaches which strike a balance between these two extremes." This statement was quoted with approval in Case 3, infra. Since there has been no substantive change in the applicable federal tax statutes, this quotation is as appropriate today as when made.

Case 2: City of Los Angeles v. Public Utilities Commission (1972) 7 C 3d 331. A general rate increase for Pacific was annulled partly because the Commission computed taxes on the basis of normalization.

Case 3: City of Los Angeles v. Public Utilities Commission (1975) 15 C 3d 680. This is the case which remanded D.83162, et al., for these proceedings. The court stated on page 684 that the Commission took the action in D.83162 in spite of the court having annulled its previous decision in this matter for failure to consider lawful alternatives in the calculation of federal income tax expense (Case 1). The court further said that the Commission set a rate which in its own words would create a windfall for the telephone companies to the detriment to the ratepayers.

Pursuant to the remand in Case 1 the Commission entered D. 80347 dated August 8, 1972 which directed further

hearings into the tax expense problems. These further hearings had not yet been held at the time of the decision in Case 2. In D.80347 we said on page 3: "For the purpose of this opinion only we will compute Pacific's federal tax expense on the basis of accelerated depreciation with flow-through." D.80347 thus ordered a substantial refund amounting to about $176 million, including interest, based on the flow-through method of computation of the federal tax expense. D.80347 also set rates which were in effect through the effective date of D.83162 rates, which was August 17, 1974. The hearings held pursuant to Case 1 were consolidated with A.53587 and resulted in D.83162 where this Commission again adopted the normalization basis for computing federal tax expense, which resulted in Case 3.

In D.74917 dated November 6, 1968, prior to the enactment of the Tax Reform Act of 1969 (TRA) effective January 1, 1970, we determined that Pacific was imprudent in not electing the accelerated depreciation option. For ratemaking purposes we imputed accelerated depreciation with full flow-through, though Pacific was paying taxes on a straight-line basis. This procedure was approved in Case 1. TRA allowed utilities to take accelerated depreciation even though they had not taken it before 1969 only if the cost of service (which includes federal income tax expense) was computed on a normalization basis. After the enactment of TRA both Pacific and General reversed their longstanding opposition to accelerated depreciation and elected it on a normalization basis. This election has resulted in the instant proceedings in which we are attempting to comply with the mandate from our Supreme Court to reach an equitable determination of this problem.

Pacific and General argue that accelerated depreciation is allowable only if normalization accounting is used because neither is eligible under IRC Section 167.1 for flow-through accounting. If normalization is not used, then the companies must revert to straight-line depreciation and

the benefits of accelerated depreciation will be lost to both the utilities and the ratepayers. We have previously agreed with this position, as has the court in Case 1, though this result is due only to the intransigence of Pacific and General in not opting for accelerated depreciation when they had the opportunity. While this Commission deplores the actions of Pacific and General, we are again compelled to agree with their interpretation of the tax law. To impute flow-through now in attempting to redress the balance between the utilities and ratepayers, we would ultimately cause the ratepayers substantially higher rates and poorer service while seriously damaging the financial position of the companies. This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator.

Thus, we are forced to again consider the question of maintaining eligibility for accelerated depreciation on a normalized basis. The primary reference for this purpose is Treasury Regulation 1.167(*l*)-(1)(h)(6).[3] It delineates when the normalization method of accounting is not used, and concomitantly, when it is used. If these criteria are not met, then accelerated depreciation in its entirety will be disallowed creating a huge tax liability for Pacific and General, which will be met with an equally huge deferred

[3] This regulation, as far as pertinent, reads as follows:

"(6) Exclusion of normalization reserve from rate base. (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking."

tax reserve account, which is paper only, as the monies credited to the deferred tax reserve have already been spent.

The same proposition prevails for ITC. Since ITC became effective in December 1971, General and Pacific have elected ratable (service-life) flow-through (Option 2).[4] This means that the amount of plant investment in the taxable year shall be apportioned on its expected service life for ratemaking purposes.

Neither Pacific nor General was eligible for ITC Option 3[5] (see Case 1, page 130), which allows full flow-through of the tax savings in the year in which the benefit occurred.

[4] IRC Section 46(f)(2), which reads as follows:

"(2) Special rule for ratable flow-through.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

"(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

"(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection)."

[5] IRC Section 46(f)(3), which reads as follows:

"(3) Special rule for immediate flow-through in certain cases. —In the case of property to which section 167(*l*)(2)(C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property."

Thus, ITC for Pacific and General will be disallowed in its entirety if the taxpayers' cost-of-service for ratemaking purposes is reduced by more than a ratable portion of the credit allowed or if the base to which the taxpayers' rate of return for ratemaking purposes is applied is reduced by more than a ratable portion of the credit.

Assumptions

This discussion and ensuing decision reflect the assumptions set forth below:

(1) Tax Reduction Act becomes effective on January 1, 1970.

(2) As a result of Case 1 and D.80347, Pacific's rates from January 1, 1970 to August 17, 1974 have been promulgated on a flow-through basis. Since these rates are final they cannot now be amended by any action of this Commission. Therefore (a) any action taken in respect to Pacific's rates will apply from August 17, 1974 until the effective date of the rates set in D.85287, which is January 5, 1976; (b) the rates set in D.85287 are subject to refund and any action taken in this decision shall adjust those rates accordingly; and (c) any action taken here shall apply prospectively to the rates to be set in pending A.55492 of Pacific.

(3) General's rates for test year 1970 in D.79367 (effective December 12, 1971) and thereafter have been subject to refund. Therefore (a) any action taken on accelerated depreciation here shall apply to the rates collected by General from December 12, 1971; (b) although ITC was not in existence in test year 1970 used in D.79367, any action taken on ITC shall apply from December 12, 1971, as General has been taking ITC since it has been available; and (c) any action taken here on ITC

and accelerated depreciation shall apply prospectively to the rates to be set in pending A.55383 of General.

(4) Neither Pacific nor General has the option to elect accelerated depreciation on a flow-through basis under IRC Section 167, et seq. (Case 1.)

(5) Both Pacific and General must use a normalization method of accounting to maintain eligibility for accelerated depreciation under IRC Section 167, et. seq.

(6) Neither Pacific nor General has the option to elect ITC on a flow-through basis (Option 3) under IRC Section 46, et seq.

(7) Normalization accounting for accelerated depreciation reduces financial risk and increases cash flow compared to the flow-through treatment for accelerated depreciation.

(8) Both Pacific and General were guilty of imprudent management in their original determination to pay federal income taxes on a straight-line depreciation basis. (Cases 1 and 3.)

(9) The quantification of a rate of return reduction because of the increased cash flow and decreased risk and vulnerability of normalization accounting is difficult and judgmental.

The Evidence

Various alternative methods presented at the hearings may be summarized as follows:

General's Proposals

1. *Three-Year Reserve and Tax Adjustment Method.* This is a variation of a previously proposed three-year pro forma method which, it was argued, was disqualified

under Treasury Regulation 1.167(l)-(1)(h)(6) because it used a deferred tax reserve balance that exceeded the amount of such deferred tax reserve for the period used in determining the taxpayers' tax expense. The current proposed method remedies this defect because it considers the additional tax expense for the same period as the deferred tax reserve. It is based on the assumption that the federal income tax will increase in proportion to growth after the test year. The method of computation is as follows:

> At test year the Commission should find a reasonable federal income tax (before ITC) and a reasonable normal growth rate. (General recommends using the compound growth in main stations for the three preceding years.) The test year tax expense would then be increased by applying the growth factor to the intrastate federal income tax (before ITC) for three years into the future and averaging. The test year federal tax expense would then be deducted from the three-year average to determine the additional tax expense to be included in the test year. This amount would then be multiplied by the net-to-gross multiplier to represent the intrastate change in revenue requirement related to the additional tax expense that must be considered for the same period as the deferred tax reserve as determined in the three-year pro forma method.

2. *Annual Reserve and Tax Adjustment.* This is an adaptation of the annual or year-to-year adjustment method (which the Supreme Court discussed in Case 3), which has the same disadvantage as the pro forma method because of its use of an out-of-period deferred tax reserve. The current adaptation of this method makes an annual adjustment for the increase in reserve and also brings the additional tax expense forward for the same time period. The additional tax expense is determined in the same manner as in the three-year reserve and tax adjustment method,

but the rates would only be adjusted one year at a time. The federal income tax before ITC, plus a normal growth rate, would be determined by the Commission and each year's calculation would be based upon the prior year's calculation until a new test year was established.

3. *The Deferred Tax Reserve as No Cost Capital.* This method is used by applying the amount in the deferred tax reserve as a component of the capital structure with zero cost assigned to it. Rate base is not reduced by the amount of deferred tax reserve. The effect is to lower the cost of capital and rate of return found reasonable in general rate proceedings.

Pacific's Proposal

Annual Ratemaking Plan. Pacific would annually tender an estimated full intrastate cost of providing telephone service, keeping as constant all the ratemaking adjustments previously adopted in the latest general rate decision and the last authorized rate of return. No new adjustments or change in authorized rate of return would be permitted but all other elements of cost-of-service would be considered. This is a slightly simplified annual rate case, which everyone agrees is permitted under the existing tax laws.

Staff's Proposals[6]

1. *Pro Forma Annual Adjustment.* Gross revenue requirement reductions are determined by annual adjustments in the deferred tax reserve for the test year and each of the next three years. The average of these four years' reductions is then applied as a gross revenue reduction in test year rates.

2. *Rate of Return Adjustment—Reduced Risk.* The authorized rate of return upon which test year gross revenue

[6] Staff refers to the Utilities Division of the Commission.

requirements are based is reduced in order to recognize the reduction of financial risk resulting from the cash flow generated by the tax savings from accelerated depreciation and ITC on a normalization accounting basis.

3. *Midpoint Flow-Through Applied to a Normalization Rate Base.* In addition to the normalized treatment of deferred tax reserve, one-half of the difference in gross revenue requirements between normalization (for accelerated depreciation) and ratable flow-through (for ITC) and a full flow-through of each is reflected in rate reductions.

4. *Normalization with Amortization of Deferred Taxes.* This is similar to the method of adjusting the expense and rate base for contributions in aid of construction. The gross revenue requirements are reduced by the reduction in rate base in the amount of the average deferred tax reserve for the test year, but the deferred tax reserve is also amortized (using the straight-line depreciation rate) by a sum also reflected in a reduction in gross revenue requirements and rates.

5. *Rate of Return Adjustment—Cost-Free Funds.* This is substantially equivalent to General's no-cost capital proposal.

The City and County of San Francisco's (SF) Proposal

SF recommends full flow-through, or in the alternative, a rate of return reduction contingent upon a favorable IRS ruling on eligibility, but in the event of an unfavorable ruling, rates to be then reset on a full flow-through basis. The purpose of this theory is to provide the companies with an incentive to obtain a favorable tax ruling, or alternatively, to amend the existing law to avoid the loss of eligibility.

The City of Los Angeles's (LA) Proposal

LA recommends a rate of return reduction up to a maximum of two percentage points,[7] while continuing the normalization treatment of tax expense. This reduction is to be quantified after considering three factors:

(1) Analysis of the financial risk reduction of a normalization as compared to a flow-through company due to the greater cash flow generated, the reduction of the need for outside financing, the reduction of the cost of embedded debt, the improvement in interest coverage, and the generally favorable effect on the cost of new capital and evalution of the utility's securities generally. (This position is supported by the city of San Diego.)

(2) The previously found imprudent management in failure to elect accelerated depreciation to avoid rewarding the utilities for their imprudence.

(3) Reflection of the phenomenon of inverse attrition, which is the opposite of the allowance for attrition that the Commission has used in the past as a regulatory tool where there is a projected diminution of the rate of return. Here, since the normalized tax reserve grows at a markedly greater rate than the other components of the utility's operations, the authorized rate of return would be exceeded in subsequent years because no reduction in rate base occurs between test years. The inverse attrition allowance set in the test year will reduce the rate of return in the future. (This is a step beyond the continuous surveillance me-

[7] For test year 1975-76, the staff calculates that the rate of return for Pacific would be 2.17 percentage points higher on a flow-through basis than on a normalization basis.

thod now in use, which only applies to earnings in excess of the authorized rate of return.)

LA recommends that ITC be treated in the same manner.

Toward Utility Rate Normalization's (TURN) Proposal

Turn proposes another method of compensating for the reduced risk of normalization by reducing the rate of return. It is calculated by discounting to present value the money which is accumulated in the deferred tax reserve and the measurement of that time value upon the rate of return allowed in addition to the normalization treatment. The method also applies to ITC using a three-year forward averaging amount (test year and two following years). In the beginning this method would produce a refund in excess of the refund produced by full flow-through.

OTHER POSITIONS

Citizens Action League (CAL). CAL supports a greater sharing of the benefits of accelerated depreciation with ratepayers than exists under normalization accounting, and urges refunds be paid in cash rather than as a bill credit.

Continental Telephone Company of California. This company would be affected by our decision here only if a refund of toll revenues collected by Pacific should be ordered.

The Los Angeles Urban League. This organization seeks equal opportunities for blacks and other minorities in all sectors of our society and is concerned over a decision adverse to Pacific which would be disastrous to Pacific's minority hiring, firing, and promotion practices under Pacific's scenario of service and construction reductions.

Los Padrinos, Inc. This is a nonprofit charitable and educational corporation of predominantly Spanish-surnamed employees of Pacific. It is also concerned about the

serious economic consequences depicted by Pacific's witnesses and urges the Commission to adopt an alternative which will preserve Pacific's eligibility for tax benefits.

The National Association for the Advancement of Colored People (NAACP). NAACP is a civil rights organization with the principal purpose of eliminating racial discrimination in every facet of American life. It urges the Commission to allow Pacific the full tax advantage of accelerated depreciation and ITC to preserve the employment of ethnic minorities and aid in employing the large number of unemployed black persons.

The Pacific Telephone Employees for Women's Affirmative Action, Southern California. This is an organization dedicated to aiding Pacific in achieving its affirmative action goals relating to women and urges action similar to the other above-mentioned groups.

DISCUSSION

One of the major difficulties in the resolution of these cases is the length of time that has transpired between the onset of the problem and its latest submission for resolution. In Case 1 the court recognized then (in 1971) that one extreme or the other in the solution would be harsh to either the utilities or the ratepayers. That proposition has now been exacerbated by the passage of years and many millions of dollars of increase in the deferred tax reserve. Now, in the event of the loss of eligibility for the tax benefits flowing from accelerated depreciation and ITC, Pacific estimates its total potential tax liability here from 1970 through the end of 1976 at $764 million, while General estimates its comparable liability at $223 million, or together almost $1 billion in potential tax liabilities. This is without regard for any rate refunds, ongoing rate reductions, and other costs that might be attributable to a retroactively assessed tax liability, such as the need for raising additional funds for plant investment, the dete-

rioration in financial position, the necessity for increased interest rates and returns on debt and equity, and a myriad of other problems involved, not the least of which are the staggering rate increases that are foreseeable as the bottom line in such a scenario. We are seeking to resolve this dilemma in a middle ground, perhaps pleasing to no one, but finally disposing of this problem by more suitably leveling the interest of the utilities and the ratekeepers. Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision. In the final analysis a loss of eligibility to the utilities would not only create service problems (though certainly not of the scope described by Pacific's) but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress. We believe that eligibility for these tax benefits should be maintained and proceed on this basis.

Accelerated Tax Depreciation

The parties recommend various positions which encompass the entire spectrum of possibilities from maintaining the status quo with normalization to a method which would refund more money than would be available under flow-through. While the alternatives submitted are plentiful, all are substantially variations on two themes: (1) reduction of rate of return; and (2) some form of reflecting the increase in the deferred tax reserve in order to further reduce the rate base (the annual adjustment method).

The utilities would prefer to maintain the status quo, though Pacific condescended to advocate what amounts to an annual rate case, merely holding the rate of return and any other test year adjustments constant while delving

into the entire cost of service each year, a solution that will solve nothing while adding to the specter of regulatory lag.

General was somewhat more generous by offering additional variations on the annual adjustment, while offsetting the increased deferred tax reserve with increased federal tax expense.

The staff basically recommended full flow-through but as a concession to compromise supported a rate of return reduction based on reduced risk only for future rates and a refund based on full flow-through for the rates subject to refund. LA recommended a maximum two percentage point rate of return reduction for the current test year 1975-1976 for Pacific, although it supports flow-through as the only proper ratemaking approach.

For General's test year the rate of return difference between flow-through and normalization was .14 percentage points in test year 1970, 1.39 in test year 1974, and 1.58 in test year 1976. (Staff Exhibit 45.) For Pacific, the pertinent years and comparable differences are as follows: Test year 1973, 1.52 percentage points; test year ending June 30, 1976, 2.17. (Staff Exhibit 46.) The flow-through basis always produces a higher rate of return because the greater the dollar amount of depreciation differential is between straightline and accelerated depreciation, the smaller the correlative federal tax expense is for the flow-through company, and the greater the earned rate of return.

While we agree that full flow-through is the proper and best ratemaking method, we shall not consider it further because both Pacific and General would be ineligible for accelerated depreciation and ITC if rates were set on a flow-through basis. We must look to some other alternative, proposed or encompassed in the entire range of possible alternatives.

All the variations on the theme of increasing the deferred tax reserve provide readily estimable items for the purpose of computing the necessary numbers to determine the gross revenue requirements and rates. On the other hand, the reduction in rate of return is subjective, highly judgmental, and most difficult of quantification, as all the parties concede. If we were to adopt reduction in rate of return, what number would we adopt? How is this number to be determined? Is the difference in rate of return because of reduced risk merely a function of the dollar difference, as suggested by LA's witness? (Exhibit 22, page 16.) If not, what other factors are used to compute the actual number? If we adopt reduction in rate of return based on the dollar differences, as computed by the staff, what justification is used to differentiate this return from the return based on normalization accounting? Do we reason that the entire reduction in rate of return is caused by the risk reduction, as we did in D.85627 (Southern California Gas Company)?

In D.83540, the decision on petition for rehearing in D.83162, we stated on page 4: "The impact of normalization upon risk, and hence upon rate of return, was taken into account in the Commission's deliberations and was one of the factors which caused us to reduce the equity return authorized for Pacific below that authorized for other California utilities of similar capital structure. The impact or normalization on Pacific's risk was not specifically discussed because it was not disputed; all parties, including Pacific, conceded that the authorization of normalization reduces risk below that which would otherwise result. This uncontradicted evidence was taken into account in fixing rate of return." To now say that we shall again reduce rate of return in D.83162 when we already conceded that it was taken into account in setting the original rate of return would be unfair as the reduced risk would be reflected twice in rate of return. We believe it fairer to use a variation of the

annual adjustment proposed, which we will call the "averaged annual adjustment".

The theory of this method is simple: Because the increase in the deferred tax reserve is deduced from rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenues will then produce less tax expense since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reduction.

General's expert witness testified (Exhibit 3, page 10): "If the deferred tax reserve is determined as of a time subsequent to the test period, tax expense for ratemaking purposes must be determined as of the same time." This principle is embodied in General's first alternative (pages 13 and 14, above), which remedies the alleged defect of the old pro forma method, which did not take into account tax expense for the same period used to calculate the reserve. (General's opening brief, page 16.) General's opening brief, page 16, describes the methodology, as follows: ". . . the deferred tax reserve is averaged three years into the future in the same fashion as pro forma normalization, and in addition, federal income tax expense is also averaged for the same three-year period by which test period tax expense and rate based is adjusted. The necessary correlation of the reserve and tax expense provided in the cited Treasury Regulation is thereby achieved (Exhibit 3, page 16)." This is exactly the methodology for the averaged annual adjustment.

General believes it fair to assume growth in the tax expense every year. The actual federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it. (Exhibit 36, Pacific; Exhibit 27, General.)[8] TR 1.167(l)-(1)(h)(6) does not discuss rev-

[8] In addition, the effective actual tax rate has been generally declining.

enue growth, nor the direction of federal tax expense, but only the time frame for two specific items. We think it equally fair to assume a tax expense for the averaged annual adjustment that decreases as the deferred tax reserve increases in each year to accurately reflect only the increase in deferred tax reserve in the same period of tax expense. Thus, we will hold constant all items of cost-of-service not directly dependent on the increase in deferred tax reserve. The computation starts with the test year figures. Using the latest available estimates, we will compute the reduction in net revenues resulting from the increased deferred tax reserve in each of the next three years, compute the resulting decrease in tax expense in each corresponding year, then average the deferred tax reserve and federal tax expense for the four-year period. These averaged annual adjustment figures for deferred tax reserve and federal tax expense will then be used in the current test years for the pending rate cases. For past years, the total of the decrease in net revenues and decrease in federal tax expense [9] will be deducted from the gross revenues computed under normalization accounting, and the difference shall be refunded. Tables 1 and 2 (Appendices B and C) show the method and results for Pacific and General, respectively. Total refunds through December 31, 1977 for Pacific are $110,785,000 and for General are $40,230,000. The current rate reduction is $31,609,000 for Pacific and $6,571,000 for General,[10] based on current test years and estimates for three succeeding years. The refund amounts contain interest at the rate of 7 percent per annum through December 31, 1977 from the time the rates were originally authorized and collection began. The deferred tax reserve amounts used are actual through 1976 and estimated thereafter.

[9] A small factor shall be added as appropriate to compensate for decreased uncollectibles and franchise taxes.

[10] This amount may be adjusted for more current estimates in A.55492 for Pacific.

Pacific's opening brief (pages 42 and 43) indicates that cost-of-service must include the total tax expense [11] for the test period and the succeeding "pro forma" priod. This means the tax expense for each of the future years will have to be estimated. While Pacific agrees that the regulations do not cover how tax expense must be estimated, it indicates that the same method used to estimate future deferred tax reserve must be used to estimate future tax expense or the procedure would be suspect and subject to IRS disapproval. No authority is cited nor is any specific method of estimating proposed, nor does the IRC and the treasury regulations direct or discuss the estimating process. We believe our method is direct, simple, and in full compliance with the applicable federal law. Eligibility will be maintained since the federal tax expense for cost-of-service purposes is computed for the same period as the deferred tax reserve. While we agree that it uses a bookkeeping fiction, it is no more fictitious, no more illogical, and no more unreasonable than the fictitious theory of normalization. In *San Francisco v PUC* (1971) 6 C 3d 119, 130-131, the court said "Both of the extreme methods (normalization and flow-through) involve a fictitious charge of federal tax expense. . . Since a fictitious figure must be used under either method it is not improper for the commission to use an additional fictitious factor to limit the harsh results. Insofar as the compromise would impose a lesser burden on Pacific than is permissible consistent with due process (lesser than the burden under imputed accelerated depreciation with flow-through), Pacific is not in a position to make due process objections." We adopt this reasoning here.

The averaged annual adjustment is actually a form of annual ratemaking. It is not objectionable because it uses

[11] General's exception to the Proposed Report makes this same point. Our discussion applies equally to this exception.

assumed constants, as these are used in an ordinary test year projection, whether or not we are considering the deferred tax reserve and the tax expense in an isolated manner. If the test year is 1970 and the rates remain in effect until the next test year, which is 1974, we have assumed that the cost-of-service has remained constant for the years 1971, 1972, and 1973. This may be unrealistic, but clearly permissible under our authority and the law. On a normalization basis, we will do the same. We will compute the deferred tax reserve and the tax expense on a normalized basis for the test year, and thereafter until the next test year those items and all other elements of cost-of-service are deemed constant. We see no difference in taking the deferred tax reserve and computing the tax expense and the rates based on those two items (and their variables) for years subsequent to the test year and averaging them back into the test year. Though the method is different, the principle is identical to the ordinary test year principle. Nor is this subject to the objection that this is a flow-through subterfuge. Everything and every method proposed by any party, including normalization as used by the companies here, is a method of flow-through. Normalization, according to Pacific, saves the ratepayers a great deal of money compared to straight-line depreciation, and there is no question that it does. But it does not approach the only sensible and realistic method of setting rates—using the actual tax expense as the cost-of-service tax expense. The method being adopted here is a more equitable and realistic method of normalization than the other proposals and the best available now.

ITC

While we agree with the Supreme Court that the effect of accelerated depreciation and ITC is identical the laws and regulations respecting them differ substantially. Thus, the specific delineation of permissible ratemaking policies in regard to maintaining ITC eligibility as set forth in IRC

Section 46, supra, requires a ratemaking treatment for ITC differing from that accorded accelerated depreciation.

There is no question that utilities which did not elect accelerated depreciation with flow-through prior to the effective date of TRA were ineligible to elect Option 3 (immediate flow-through of ITC when it became effective in December, 1971. In D.85627 (Southern California Gas Company (SoCal)), we imposed a rate of return reduction because of the reduced risk and increased cash flow generated in part as a result of SoCal's election of Option 2 for the years 1975 and 1976, when ITC was increased for those years from 4 to 10 percent for utility plant additions and from 7 to 10 percent for transmission plant additions.[12] It is our position that ITC eligibility was not affected by D.85627. However, the Internal Revenue Service (IRS), in response to a request from SoCal, issued an alleged ruling (Exhibit 52) of which we were notified by letter dated November 22, 1976. In this alleged ruling the IRS concludes that ITC will not be available to SoCal for federal income tax purposes when the benefits to be derived therefrom are treated for ratemaking purposes in the manner provided in D.85627 (as affirmed by D.86117). Our Supreme Court has granted a writ of review on SoCal's appeal of D.85627 and 86117 and has heard oral argument on the matter. While the IRS ruling is not the final determination of this issue, we believe that a rate of return reduction is not warranted in this proceeding in any event. We also, in this proceeding, reject the concept of a permanent reduction in rate of return for past as well as future rates, as recommended by some of the parties.

We do not believe a rate of return reduction to be any more of a subterfuge for accomplishing flow-through than any of the other methods presented here nor are we reject-

[12] This increase in ITC was extended through 1980 in the bill signed into law on October 4, 1976.

ing it for that reason. In a full rate case, all the elements of cost-of-service are considered in the process of arriving at a reasonable rate of return. Here, all the parties advocating this method base it solely on the number of dollars of desired refund, and not vice versa. In this proceeding, where we are addressing ourselves to changes in the level of ITC which may be expected to occur beyond the test year, we prefer a more precisely ascertainable result.[13] For these reasons we are adopting for the purposes of ITC and eligibility thereunder the only method that appears to encompass all the factors we desire, the annual adjustment. Sometime prior to the first day of each year after (and including) the test year, we shall recalculate the ITC for the coming year on the basis of the best estimates then available and shall adjust the rates accordingly at the beginning of the year to provide for the full year-to-year growth in the annual amount of ratable flow-through (Option 2). The difference in tax expense between that occurring on the test year because of Option 2 and that estimated for the adjustment year would be computed on the most recent estimate for eligible plant additions. The intrastate factor would be applied and the charge would be converted to revenue requirement by the proper net-to-gross multiplier and applied as an adjustment to decision rates for the year following the test year. Thereafter, we shall delete the earliest year and use the next year to establish the tax expense difference, and adjust the then current rates.[14] For Pacific, the refund obligation through December 31, 1977 for ITC is $51,231,000 and the approximate current rate reduction is $23,346,000 (Table 3, Appendix D). For General, the

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[13] This reasoning applied equally to accelerated depreciation.

[14] Annual adjustments may also be implemented when a Commission decision becomes effective after the beginning of the first annual adjustment period. The first annual adjustment will merely be incorporated in any such decision.

comparable figures are $15,649,000 (gross) and $4,771,000 (Table 4, Appendix E).

We are rejecting all the other proposed treatments for varying reasons, principally that they either cause or tend to raise doubts about eligibility, or do not adequately redress the balance between the ratepayers and the utilities.

Imputed Flow-Through of Accelerated Depreciation

In reviewing the record of this proceeding it has come to our attention that certain old vintage plant additions were not previously considered in the ratemaking process. We shall discuss Pacific and General separately.

Pacific

In D.74917 dated November 6, 1968 we imputed flow-through of accelerated tax depreciation for 1967 vintage plant using a 1967 test year. In D.77984 dated November 24, 1970 (test year 1970) the normalization treatment for accelerated depreciation was ordered for Pacific. When this decision was annulled the rates reverted to those set in D.74917 (test year 1967). In D.80347 dated August 8, 1972 rates were increased using 1970 vintage plant additions to determine the flow-through of accelerated depreciation ordered there. The rates set in this final decision were effective until August 17, 1974, the effective date of the rates set in D.83162. The net effect of this history is that no accelerated depreciation for 1968 and 1969 vintage plant additions was ever reflected in Pacific's rates, even though our Supreme Court approved the imputed flow-through of accelerated depreciation.

In Exhibit 32 in A.53587 (and the A.51774 rehearing), this imputation was proposed for the two years in question. We shall adopt this recommendation. Further, we shall continue this imputation through Pacific's test years 1973 in D.83162 and 1974-1975 in D.85287 and shall order here an ongoing reduction in pending A.55492 (test year

1975-1976) for this flow through item. These amounts are as follows:

Flow-Through of 1968 and 1969
Vintage Plant Additions
(Table 5, Appendix F)

(Dollars in Thousands)	
D.83162 (Test Year 1973) 8/17/74 to 1/4/76	$24,158
D.85287 (Test Year 1974-75) 1/5/76 to 12/31/77	19,412
	$43,570
Ongoing reduction (TY 1975-76) A.55492	$ 5,539

SUMMARY OF PACIFIC REFUNDS AND
RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS	
Accelerated Tax Depreciation (Table 1, Appendix B)	$110,785
ITC (Table 3, Appendix D)	51,231
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	43,570
TOTAL REFUNDS	$205,586
RATE REDUCTIONS (A. 55492)	
Accelerated Tax Depreciation (Table 1, Appendix B)	$ 31,609
ITC (Table 3, Appendix D)	23,346
Flow-Through of 1968 and 1969 Vintage (Table 5, Appendix F)	5,539
TOTAL RATE REDUCTIONS	$ 60,494
TOTAL REFUNDS AND RATE REDUCTIONS	$266,080

General

A similar situation exists for General but it is limited to 1969 vintage plant additions. In D.75873 dated July 1, 1969 we imputed flow-through of accelerated depreciation for 1968 vintage plant using a 1968 test year. In D.79367 dated November 22, 1971 increased rates were ordered using the normalization treatment of accelerated depreciation beginning with 1970 vintage plant additions. Thus, 1969 vintage plant additions were never reflected in General's rates, all of which have been subject to refund since D.79367.

In Exhibit 5-R in A.53935 (and the A.51904 rehearing), this imputation was proposed for 1969. We shall adopt this recommendation and shall continue this imputation from December 12, 1971 (the effective date of D.79367) through test years 1970 (D.79367), 1974 (D.83779), and 1976 (D.87505).

However, in Table 6 of Exhibit 2, General claimed credit for refunds and rate reductions already made as a result of the annulment of D.78851 of Pacific.[15] In D.83778 dated November 26, 1974 we said, on page 41:

> "The refunds already made by General are attributable to the annulment of Decision No. 78851 while the settlement revenue losses to General are attributable to the annulment of that decision and also to the difference between Pacific's rates authorized in Decision No. 80347 and Pacific's annulled rates."

Failure to give General credit for these sums would amount to requiring double refunds. Since this would be inequitable, we are offsetting the losses already incurred

[15] This claim was also made in General's exceptions to the Proposed Report.

against the refunds and rate reductions required of General by this decision.[16]

SUMMARY OF GENERAL NET TOTAL REFUNDS AND RATE REDUCTIONS THROUGH DECEMBER 31, 1977

(Dollars in Thousands)

REFUNDS

Accelerated Tax Depreciation (Table 2, Appendix C)	$34,987
ITC (Table 4, Appendix E)	15,363
Flow-Through of 1969 Vintage (Table 6, Appendix G)	
a. D.79367 (TY 1970) 12/12/71 to 12/20/74	9,244
b. D.83779 (TY 1974) 12/21/74 to 7/17/77	7,245
c. D.87505 (TY 1976) 7/18/77 to 12/31/77	670
TOTAL REFUNDS	$65,440

RATE REDUCTIONS (D.87505)

Accelerated Tax Depreciation (Table 2, Appendix C)	$ 6,571
ITC (Table 4, Appendix E)	4,771
Flow-Through of 1969 Vintage (Table 6, Appendix G)	1,311
TOTAL RATE REDUCTIONS	12,653
TOTAL REFUNDS AND RATE REDUCTIONS	$78,093

[16] In applying the credit, reductions are treated separately for 1971, 1972, and 1973 (from 1/1/73 to 9/22/73 only) and compared to refunds computed for those years, in accordance with the principle used by General in Exhibit 2, Table 6. Reductions in refunds are made first to the imputed flow-through refunds, then any remaining reduction is credited to ITC, and finally and remaining reduction is credited to accelerated tax depreciation. (See Table 7, Appendix H.)

SERVICE

Pacific has depicted a service and employment scenario of horrendous proportions in the event it loses eligibility for accelerated depreciation and ITC, and assuming a back tax payment of $764 million, rate refunds of $73 million and an ongoing rate reduction of $62.6 million. In 1972 and 1973, however, Pacific refunded $176 million together with a rate reduction of $90 million and had no significant employee layoffs, no deterioration in service and no adverse effects on earnings.

Because the eligibility of both companies is unaffected in our judgment, we foresee no meaningful change in the operations and quality of service, number of employees, level of earnings, impairment of financial integrity, or other deleterious consequences as predicted by Pacific. Thus, the companies are put on notice that any deviation from their current service indices, objectives, standards, and our General Order No. 133 shall be monitored and, when appropriate, punished to the fullest extent of the law. For these purposes, we particularly emphasize Pacific's 1976 Service Objective List admitted as Exhibit 43 in its pending A.55492 as exemplary of the service standards expected, together with the ultimate determination, in the same proceeding, of the acceptable level of held primary orders.

MISCELLANEOUS CONTENTIONS

Pacific and General have discussed many other points, some pertinent, some not. We shall briefly discuss due process, actual results of operations, confiscatory rates, retroactive ratemaking, credit for revenues authorized but uncollected, and settlement adjustments.

Pacific relies heavily on the case of *West Ohio Gas Company (No. 2) v Public Utilities Commission* (1935) 294 US 79. There the regulatory agency had, in setting a rate in 1933, chosen to rely exclusively on data from 1929, ignor-

ing available revenue and expense data from 1930 and 1931. The court said this was an unconstitutional procedure. Our situation here is easily distinguishable, as we are taking into account the actual deferred tax reserve and ITC amounts for the past years and computing the functional variables from that actual number. Our Supreme Court in *Los Angeles v PUC* (1975) 15 C 3d 680, has already found this procedure to be proper since the tax expenses and reserves under accelerated depreciation vary abnormally with respect to the other components of a utility's finances. The court said on page 703, "Simply to recognize this fact is not to deny due process."

Further, the actual results of Pacific's operations indicate a financial picture much brighter than depicted by Pacific. It is true that the dividend on common stock has not been increased since 1961, as Pacific alleges, but that is a management decision which is not directly related to its per share earnings or any other indicia of financial progress. In 1961 Pacific had 104 million common shares outstanding while at the end of 1975 it had over 168 million such shares and contemplates over 181 million at the end of 1976. Thus, the total dividends paid now are approximately two-thirds greater than in 1961, to over $202 million in 1975. Further, the earnings per share increased from $1.46 in 1970 to $1.82 in 1975 and $2.06 in 1976, all on an increased number of outstanding shares. There has been an increase in the number of employees, an increase to earned surplus from 1972 to 1975 of the staggering sum of $245 million, and an increase in construction budget from 1971 to 1974 of $225 million. And this was all accomplished while refunding $176 million with an ongoing rate reduction of $90 million per year. In this be confiscation, let there be more of the same. In view of these facts, Pacific's arguments regarding confiscatory rates are untenable and rejected.

Neither do we agree with Pacific's position that the imposition of a penalty for imprudence would constitute im-

proper retroactive and punitive ratemaking since this procedure has already been approved by the Supreme Court (6 C 3d 119). Penalties for imprudence, like penalties for civil or criminal wrong, have nothing to do with rates; they are punishment. But we are not imposing a penalty here; we are determining the proper basis for setting rates.

Pacific has suggested that it is appropriate, in the event the Commission orders a refund in this matter, to deduct from the amount of refund the revenues previously authorized but not collected because it has failed to earn its authorized rate of return. If rate of return has not been earned, the remedy for that, as clearly set forth by the court in 15 C3 680, is to seek rate relief, which both companies have done and are presently doing. Further, this recommendation would guarantee the authorized rate of return. Because it is axiomatic that this Commission does not guarantee the return, but merely provides an opportunity to earn it, the requested credit would be inapposite.

Since our action will not render Pacific ineligible, we need not answer its argument that this would unduly burden interstate commerce, particularly as no evidence on this point was tendered.

The rates to be filed by the utilities pursuant to this order will, of course, reflect settlement payments between utilities. However, we will not authorize any retroactive settlement adjustments associated with refunds resulting from this order.

Refunds in the Form of Stock

It was suggested in the event a refund was ordered that it be accomplished via the issuance of capital stock of Pacific and General. The companies introduced a great deal of material setting forth the problems involved with this idea. The major potential problems are with the Securities & Exchange Commission, the difficulty of issuing minute fractional shares for small refunds to ratepayers, the large

cost of such a program, and the Commission's authority to order such a securities issue. No party supported this concept in its present form. We shall not order it.

REFUNDS AND REDUCTIONS

Refunds in the past have been made in direct proportion to the billing of the various customers without regard to class of service. In this case it was suggested that refunds be made only to residential customers on the theory that since business customers include telephone service cost as part of their cost of doing business, they are being paid by the consumer for the cost of the phone service. A refund theoretically would then create a windfall for the business phone customers since no refunds by the business customers would be made to its customers. It can also be argued, however, that the amount of any refund to the business customer would be used to reduce the cost of business for the period in question and thereby would be reflected in lower or stable prices. In our opinion there is no evidence, one way or the other, in this proceeding to support either view.

Another suggestion was to refund to all customers on a per capita basis, meaning that the total amount of the refund would be divided by the total number of customers of the company and the same dollar amount refund would be given to each customer whether residential or business. Since the number of residential customers is much greater than business customers, and as residential revenues approach 50 percent, it is apparent that individual business customers on average pay much greater monthly revenues to the phone companies than the individual residential customers. This proposal, for example, would have the effect of giving the city of Los Angeles, General Motors, and every individual the same amount of refund. In the case of the residential customers, their refunds might well exceed their monthly bills.

Pacific and General will be directed to file proposed refund plans. Approval, disapproval, or modification of the proposed plans will follow by subsequent Commission order.

The ongoing prospective rate reductions ordered herein shall be reflected in rates for all current subscribers by a uniform proportional reduction in the recurring basic exchange primary service rates. To insure that rates for competitive services are not reduced (since those rates are generally priced as nearly as possible at full cost) we are directing that only rates for basic exchange primary service be reduced. With respect to central office centrex service the reductions shall be made on the trunk rate per station.

IRS RULING REQUEST

The companies have suggested that any proposed action changing the method of normalization now being used should allow the continuance of existing rates, either by putting the rates aside in a trust fund, as suggested by the Supreme Court, or keeping them subject to refund as at present, until such time as a ruling can be rendered by the IRS regarding the retention of eligibility under the method adopted by this Commission for treating the tax expense problems. This is based on the theory that if the IRS disapproves the proposed treatment the present method of accelerated depreciation shall continue in effect, or another proposed method may be submitted for a ruling. But the companies' requests provide no incentives to obtain an expenditious advance IRS ruling, and might lead to further delay in the implementation of the refunds contemplated in this order. Moreover, General's expert witness Nolan indicated that there are some instances where the IRS will not issue an advance ruling, nor does the IRS necessarily advise in advance that it will not issue such a ruling. The supplicant merely waits and hopes. Nolan also said that the more difficult the problem, the more

likely the IRS is to avoid issuing an advance ruling. We have here a case of first impression under the tax laws, and we think an advance ruling within a reasonable time is not probable. Moreover, the opportunities for such action by the utilities have been ample in the past, yet they took no such action. For these reasons we think that their proposals are inappropriate.

Exceptions to Proposed Report

We shall discuss here, where necessary, the exceptions that have not been discussed elsewhere in this opinion.

Pacific

Pacific's exceptions generally fall into two categories:

1. Since D.83162 was issued in August 1974, its earnings have been below the authorized rate of return and it is improper to order refunds and rate reductions in such circumstances. We have already discussed this point elsewhere, and concluded otherwise. There is nothing sufficiently meritorious in Pacific's exceptions in this area that have not been raised, discussed, and disposed of by this Commission, or our Supreme Court.

2. Pacific's eligibility for accelerated tax depreciation and ITC is endangered by the proposed treatment of these benefits.

(a) *Accelerated Tax Depreciation.* Pacific complains of the use of recorded data for historical periods, but in its brief cited the *West Ohio Gas* case (supra) as requiring the recognition of such data. Its position is inconsistent and varies with the direction the wind is blowing. Further, there is no prohibition in proper ratemaking or the IRC sections in question which bar this procedure.

Pacific also complains of the failure to use the pro rata requirements in Treasury Regulation 1.167(*l*)-1(h)(6)(ii). It overlooks the discussion on page 3 of Exhibit 16 sponsored by staff witness John Quinley, where the use of the pro rata percentage of 46.33 is shown. Mr. Quinley explains the offsetting working cash adjustment which produces a combined effect of 50 percent as the proper figure to be used in determining the average deferred tax reserve and its ultimate revenue effect. Footnote 4, Table 1, Exhibit 16, reflects this combined effect, as does Footnote 4, Table 1, Exhibit 10-A (sponsored by Pacific), which uses the identical percentage as its Table 1 is identical to Table 1 of Exhibit 16.

The other exceptions with respect to accelerated depreciation have been either mentioned or explained elsewhere and merit no further discussion.

(b) *Investment Tax Credit.* Pacific cites proposed treasury regulations allegedly relating to its interpretation of our ITC treatment. These proposals in our judgment do not effect the validity of our treatment and have no force or effect, in any event, being mere proposals. We reiterate that our treatment of ITC is akin to an annual ratemaking procedure. We see nothing in law or logic that prohibits this treatment.

General

The thrust of General's exceptions relates to the alleged ineligibility for accelerated depreciation which would occur as a result of the treatment of that subject in the Proposed Report. General alleges that the *total* tax expense must be considered for the same period for which the deferred tax reserve is estimated, and the Proposed Report considers only the reduction in tax expenses. This is not the case, as the reduction in tax expense for years after the test year is used to reduce the *test year tax expense* used in the succeeding year. The effect is to reduce each succeeding year's tax expense, but the entire tax expense is used for the appropriate period. General also alleges that the proposed method is exactly like the old pro forma method, except

for the time period. That is correct, because the failure to consider the deferred tax reserve for the same period as the tax expense is the alleged defect of the old pro forma method regarding eligibility. The Averaged Annual Adjustment remedies this defect by considering the two required items separately for the same period. While the effect is the same as pro forma, we are specifically complying with the existing tax laws by using a proper method to compute the revenue requirement. It must also be noted that this method complies exactly with the method (though not the assumptions) recommended by General and its witnesses.

We have already discussed and decided the other major exception: the double refund effect for revenues authorized but not collected because of Pacific's prior refunds.

There is no retroactive ratemaking involved here since all General's rates since November 22, 1971 have been subject to refund. The fact that ITC was not previously considered does not make it res adjudicata, nor does it prevent this Commission from reflecting its effect where possible. That is what we are doing by this decision.

LA

LA objects to the failure of the Proposed Report to decide the constitutionality of the relevant tax laws under the Tenth Amendment to the U.S. Constitution. We already decided that question in the affirmative in D.83778 and see no reason to go into the matter again.

We have previously discussed, directly or indirectly, all the other matters raised in LA's exceptions.

TURN

TURN filed two exceptions, one relating to its proposed method of determining the amount of refunds (discussed earlier), and the other relating to the effective date of the Proposed Report. We see no need to consider its exceptions.

EPILOGUE

We desire to discuss the wisdom of using the tax laws for the purpose of providing a capital subsidy (in this instance, phantom taxes) from the taxpayers (in this instance, the ratepayers) to a special interest group (in this instance, state-regulated utilities). This occurs because every dollar of taxes that the utilities pay is obtained in rates from the ratepayer, even when the utilities can defer, and perhaps never pay the taxes collected in rates. The regulators must essentially order two dollars to be paid to the utility by the ratepayer for each dollar in taxes avowedly to be paid by the utility. This seems to us to be a wasteful use of resources as well as a legally sanctioned subsidy to the utility from the ratepayer without the latter's consent. The money is not being contributed by investors in the usual manner, but is being contributed in the form of rates by the ratepayer on a two-for-one basis and not on a one-for-one basis, as it the case for traditional investment capital. The funds are being obtained from the ratepayers under the guise of taxes, while Congress has decreed that the money so collected as taxes need not be used as taxes by the utilities, but may be used by the utilities for whatever purposes they desire. There is no restriction on the use of these funds in the tax laws. The taxes collected, but not paid, in essence amount to a direct capital subsidy which the utilities may use as unrestricted capital. Nothing is paid to the ratepayers for this investment use of the ratepayers' money as would be paid to traditional investors. Thus, this is free capital, and this is occurring in a free enterprise system which traditionally rewards venture and investment capital!! Here, the converse is true. The ratepayers are actually being penalized instead of being compensated for this subsidy. Their money is being involuntarily contributed on a two-for-one basis, and no return is forthcoming on any basis. We think this is grossly unfair and should be more forcefully presented by the utilities, by the regulatory agencies, and by con-

sumer organizations. Congress has created a situation where in California both the utilities and the ratepayers feel they are being whipsawed by these tax laws and the actions of this Commission in attempting to be fair to all sides. This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered, for whatever reason.

What this Commission proposes and strongly supports, in lieu of this hidden subsidy and no-cost capital contribution to the utilities by the ratepayers (we mean at no cost to the utilities), is the elimination of the income tax upon regulated utilities to be replaced with a gross receipts tax (or, for energy and water utilities, a per unit of consumption tax), as a surcharge to all billings paid by the ratepayers, to be collected by the utilities and paid directly to the IRS. This surcharge would be indicated as such on the utility bills and would not be included in the utility cost-of-service. It could easily be structured to provide revenues to the treasury equivalent to that now being *paid* as income taxes by the utilities. It would eliminate the ratepayers' involuntary and hidden subsidy to the utilities because what they pay in gross receipts tax is what the IRS gets on a dollar-for-dollar basis. If the utilities desire to obtain funds from the ratepayers for the purpose of expansion and investment, let it be done forthrightly by direct subsidy so the ratepayers will have knowledge and the opportunity for input. Let the ratepayers share in whatever benefits might accrue to the utility as the result of any such investment by the ratepayers. We see no reason why the ratepayers, in their role of capital investors, should not share in the fruits of their investment. We believe the tax laws are not the proper medium for the creation of involuntary investment capital. Tax law gimmickry should not tilt or distort the balance necessary between state-regulated utilities and ratepayers.

The gross receipts tax would simplify the job of Congress in levying taxes and simplify the job of the regulatory agencies in setting rates, while preserving the rights of both the utility and the ratepayers. It would create faster rate relief on the part of regulatory agencies and maintain the utilities on a solid financial basis, instead of requiring everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws and the concommitant uncertainty and delays.

Findings

1. Pacific and General were imprudent in failing to select accelerated depreciation when that option was available under the federal tax laws. This imprudence denied the companies the option to elect flow-through accounting for ITC and accelerated depreciation purposes.

2. Flow-through of the tax benefits accruing under accelerated depreciation and ITC is the best method of handling these benefits for the purpose of balancing the interest of the ratepayers and the companies for ratemaking purposes.

3. Pacific and General are ineligible to elect flow-through accounting for accelerated depreciation and ITC for ratemaking purposes pursuant to IRC Section 167, et seq. and Treasury Regulation 1.167, et seq. Normalization accounting is the most appropriate method available to Pacific and General. Under the normalization method we are adopting for ratemaking purposes, tax depreciation expense for ratemaking purposes will be computed on a straight-line basis while federal taxes will be computed on an accelerated depreciation basis. The difference between the two tax computations will be accounted for in a deferred tax reserve. The average sum of the test year deferred tax reserve and the deferred tax reserve for the

three next subsequent years shall be deducted from rate base in the test year. As a result of each of the deductions from rate base federal tax expense will be recomputed on the same basis in the test year for the test year and the three corresponding subsequent years, thus matching the estimated tax deferral amount for each period with the estimated federal tax expense for the same period. This method complies with Treasury Regulation 1.167(*l*)-(1)(h)(6) and is normalization accounting.

4. For ITC we shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of ITC estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), and recomputing federal tax expense and gross revenue requirements based on that new estimate for each year between rate cases. This method complies with the requirements of ratable (service life) flow-through selected by the utilities under IRC Section 46.

5. The methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in these reserves compared to the other components of cost-of-service used in computing rates.

6. The methods adopted in this order as described in Findings 3 and 4 comply with the mandate of the California Supreme Court set forth in *City of Los Angeles v Public Utilities Commission* (1975) 15 C 3d 680.

7. The methods described in Findings 3 and 4 fairly balance the interests of the ratepayers and the utilities and avoid harsh results to either as a result of the tax benefits accruing under accelerated depreciation and ITC.

8. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 3 for accelerated depreciation is $110,785,000, including interest at 7 per-

cent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 1. The current rate reduction under this method is $31,609,000.

9. The gross amount to be refunded by General to its ratepayers under the method described in Finding 3 for accelerated depreciation is $40,230,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Tables 2 and 7. The current rate reduction under this method is $6,571,000.

10. The amount to be refunded by Pacific to its ratepayers under the method described in Finding 4 for ITC is $51,231,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 3. The current rate reduction under this method is $23,346,000.

11. The gross amount to be refunded by General to its ratepayers under the method described in Finding 4 for ITC is $15,649,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Table 4. The current rate reduction under this method is $4,771,000.

12. The maintenance of eligibility under the federal tax laws to allow Pacific and General to use accelerated depreciation and ITC is beneficial to both the ratepayers and the utilities and is an important goal of this Commission in this decision.

13. It is reasonable to order a uniform proportional reduction in the recurring basic exchange primary service rates. With respect to central office centrex service it is reasonable to make the reductions on the trunk rate per station.

14. It is reasonable to impute flow-through of 1968 and 1969 vintage plant additions for Pacific and 1969 vintage

plant additions for General, as the Supreme Court has previously approved this procedure in *San Francisco v. PUC* (1971) 6 C 3 119, and accelerated depreciation of these vintages has never been reflected in rates.

15. A gross receipts tax surcharge would abolish the "two-for-one" collection of income taxes from the ratepayers in rate setting for utilities and would allow lower utility rates since the gross receipts tax would allow a dollar-for-dollar collection of taxes *paid* by the utilities to the federal government.

16. As long as plant investment of the utility continues to expand, the deferred tax reserve is actually a tax saving and not a tax deferral.

17. It is unfair and unreasonable to use the tax laws to create investment dollars flowing from the ratepayers to the utilities on which the ratepayers do not receive any return.

18. The gross receipts tax surcharge would eliminate the involuntary capital contribution incurred by the ratepayers and would abolish the windfall to the utilities by allowing them to collect taxes from the ratepayers which they may never have to pay.

19. The investment tax credit is a tax saving and not a tax deferral.

20. A gross receipts tax surcharge will prevent the distortion of the tax laws to create subsidies from the ratepayers to the utilities in the setting of rates.

21. In computing the refunds and rate reductions computed herein, this Commission has used recorded figures, where available, for the periods in question.

22. The reduction and refunds of rates authorized by this decision are justified and reasonable, and the present rates as they differ from those prescribed therein, are for the future unjust and unreasonable.

23. No revenue adjustments for settlements by Pacific and General with interconnecting carriers will be allowed for the refund period.

24. The amount to be refunded by Pacific to its ratepayers pursuant to Finding 14 is $43,570,000, including interest at 7 percent per annum from the date of the respective order entered from which refunds are being required, as set forth in Appendix F. The current rate reduction under this method is $5,539,000.

25. Because of revenues authorized, but not collected, General is entitled to credit for certain sums refunded and lower rates set due to *San Francisco v PUC* (1971) 6 C 3 119 and D.78851 of Pacific. It is reasonable to offset these amounts against the other refunds required herein, on an annual basis only, first reducing the imputed flow-through of accelerated depreciation under Finding 14, then the ITC refund, and lastly, the accelerated tax depreciation refund.

26. The net amount to be refunded by General to its taxpayers, pursuant to Findings 14 and 25, is $17,159,000, including interest at 7 percent per annum from the date of the respective orders entered from which refunds are being required, as set forth in Appendix G. The current rate reduction under this method is $1,311,000.

27. As a result of Finding 25, the refunds due from General, pursuant to Findings 9 and 11, are reduced to the net sums of $34,453,000 (Finding 9) and $13,828,000 (Finding 11).

28. The total net refunds due from Pacific and General, and the total current and/or ongoing rate reductions required respectively, are summarized in the tables on page 32 (for Pacific) and page 34 (for General).

CONCLUSIONS

1. The methods described in Findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation

and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General.

2. This Commission does not guarantee the utility the rate of return authorized in rate proceedings, but merely provides an opportunity to earn that return.

3. The method described in Finding 3 for accelerated depreciation for Pacific and General is a normalization method of accounting.

4. The method contained in Finding 4 for ITC complies with the ratable (service life) flow-through option of ITC under IRC Section 46.

5. The imputation of flow-through of the accelerated tax depreciation benefits for 1968 and 1969 vintage plant additions for Pacific and 1969 vintage plant additions for General is a proper ratemaking procedure and does not affect eligibility under the TRA of 1969.

6. The rates being set herein are not confiscatory.

7. The offset allowed General due to the revenues authorized, but not realized, is a proper ratemaking procedure.

8. There is no retroactive ratemaking ordered in this decision.

Order

It Is Ordered that:

1. The Pacific Telephone and Telegraph Company shall refund the sum of $205,586,000 (computed as of December 31, 1977), being the total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant addition on a flow-through basis, as determined herein pursuant to Findings 3, 4, and 14. This

amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

2. General Telephone Company of California shall refund the sum of $65,440,000 (computed as of December 31, 1977), being the net total of the amounts due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined herein pursuant to Findings 3, 4, 14, and 25. This amount includes interest at the rate of 7 percent per year from the respective effective dates of the rates being refunded.

3. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file refund plans for all current (at the time of filing of the plan) subscribers. This plan shall be filed within thirty days after the effective date of this order. This plan must be approved by an order or resolution of the Commission.

4. The methods described in Findings 3, 4, and 14 shall be applied to all future rates of The Pacific Telephone and Telegraph and General Telephone Company of California.

5. The filings required for the continuous surveillance of earned rate of return as previously ordered in D.83540 and D.83778 are no longer required.

6. The Pacific Telephone and Telegraph Company shall reduce current rates by the sum of $60,494,000 (computed as of December 31, 1977), being the total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, and accelerated depreciation for 1968 and 1969 vintage plant additions on a flow-through

basis, as determined herein pursuant to Findings 3, 4, and 14.

7. General Telephone Company of California shall reduce current rates by the sum of $12,653,000 (computed as of December 31, 1977), being the net total of the reductions due under the recomputation of accelerated depreciation with normalization, investment tax credit on the service life flow-through basis, accelerated depreciation for 1969 vintage plant additions on a flow-through basis, and certain offsets thereto, as determined pursuant to Findings 3, 4, 14, and 25.

8. The Pacific Telephone and Telegraph Company and General Telephone Company of California shall prepare and file tariffs reflecting such reductions on a uniform proportional basis on recurring basic exchange primary service rates, and with respect to central office centrex service the reductions shall be made on the trunk rate per station. Such tariffs shall be filed within thirty days after the effective date of this order and shall not become effective until approved by order or resolution of this Commission.

9. Pacific and General shall not recompute intercompany EAS or other settlement amounts between themselves or with other independent companies as a result of the refunds or rate adjustments ordered herein except for busniess done on or after the effective date of this order.

10. In the event the refund plans and tariffs required to be filed by this order are effective after December 31, 1977, the amounts shown in Ordering Paragraphs 1, 2, 6, and 7 shall be recomputed to the appropriate effective date of the refund plan or tariff filing, with interest as computed in Ordering Paragraphs 1 and 2.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 13th day of September, 1977.

Robert Batinovich
President

Richard D. Gravelle

Claire T. Dedrick
Commissioners

I will file a written dissent.
/s/ Vernon L. Sturgeon
Commissioner

I will file a dissent.
/s/ William Symons, Jr.
Commissioner

I will file a concurrence.
/s/ Richard D. Gravelle

Certified as a True Copy
of the Original

/s/ H. L. Farmer

Assistant Executive Director
Public Utilities Commission
State of California

Appendix A

List of Appearances

Applicants: Robert M. Ralls and *Robert Dalenberg,* Attorneys at Law, for The Pacific Telephone and Telegraph Company; *John Robert Jones, A. M. Hart,* and H. Ralph Snyder, Jr., Attorneys at Law, for General Telephone Company of California.

Interested Parties: Thomas M. O'Connor, City Attorney, and *Robert Laughead,* for City and County of San Francisco; Robert W. Russell and *Manuel Kroman,* for Department of Public Utilities & Transportation, City of Los Angeles; *George R. Gilmour,* Attorney at Law, for TURN; *James F. Crafts, Jr.,* Attorney at Law, and *Del Williams,* for Continental Telephone Company; *Louis Possner,* for City of Long Beach; John W. Witt, City Attorney, by *William S. Shaffran,* Deputy City Attorney, for City of San Diego; *Alexander Googooian,* City Attorney, for City of Bellflower; Burt Pines, City Attorney, by *Leonard L. Snaider,* Deputy City Attorney, for City of Los Angeles; *Jack Krinsky,* for Ad Visor, Inc.; *Dina G. Beaumont,* for Communications Workers of America; *Thelma Garcia,* for Pacific Telephone Women Employees for Affirmative Action; *Joseph J. Salazar* for Los Padrinos, Inc.; *William M. Bennett,* attorney at law, for Consumers Arise Now, and himself; *Diamantes P. Katsikaris,* for Independent Taxpayers Union of California, Inc.; *Timothy J. Sampson,* for Citizens Action League; and John Mack, by *Ballard W. Brooks,* for Los Angeles Urban League.

Commission Staff: *Timothy Treacy,* Attorney at Law, *J. D. Quinley,* and *K. K. Chew.*

Appendix B
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TABLE 1

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

				Net Revenue Reduction						Refunds by Decision and Year's Rates Effective	
Test Year	Depreciation Differential [1]	Federal Tax Effect [1]	Average Reserve for Deferred Taxes [1]	Normalization [2]	Average Annual Adjustment [3]	Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Normalization [7]	Year	Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
				(DOLLARS IN THOUSANDS)							
1973	$148,963	$ 71,502	$136,787	$12,106	$24,418	$12,312	$11,364	$480	$24,156	1974	$ 11,501 [9]
										1975	30,623 [9]
										1976	356 [9]
1974-5	207,825 [12]	99,756	267,925 [12]	23,711	38,687	14,976	13,823	644	29,443	1976	33,836 [10]
										1977	34,469 [10]
						Total Refunds Through December 31,				1977	$110,785
1975-6	235,807 [12]	113,187	374,396 [12]	33,134	49,212	16,078	14,840	691	31,609	1978	31,609 [11]
					Annual Ongoing Reduction in Excess of Normalization						$ 31,609

TABLE 1

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 10-A, Table 1, Columns (A) and (D). Tax at 48% of Column (A).

[2] Exhibit 10-A, Table 2, Normalization ÷ NTG (1.962 for 1973 and 1.966 for other test periods).

[3] Exhibit 16-A, Table 2-A, Column (B) ÷ NTG.

[4] Column (E) minus Column (D).

[5] Column (F) × .92307 [(F) × .48/1 — .48].

[6] **Effects of state income tax and uncollectibles (.039 × Col. (F) for T.Y. 1973 and .043 × Col. (F) for T.Y. 1974-75 and 1975-76).**

[7] (F) + (G) + (H).

[8] **Col. (I) adjusted as per Exhibit 34, page 4 and Exhibit 41, Interest added at the rate of 7% per year for 1974-77.**

[9] **D.83162 rates effective 8-17-74 to 1-4-76.**

[10] **D.85287 rates effective 1-5-76.**

[11] **A.55492 test year data adjusted to most recent estimates.**

[12] **Average of two calendar years.**

Appendix C

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Table 2

General Telephone Company of California Intrastate Operations

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO LIBERALIZED TAX DEPRECIATION

Test Year	Depreciation Differential [1]	Federal Tax Effect [1]	Average Reserve for Deferred Taxes [1]	Net Revenue Reduction: Normalization [2]	Net Revenue Reduction: Average Annual Adjustment [3]	Net Revenue Reduction: Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Normalization [7]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
				(DOLLARS IN THOUSANDS)							
1970	$ 3,565	$ 1,711	$ 856	$ 71	$ 1,621	$1,550	$1,431	$255	$3,236	—	—
										1971	$ — [9,12]
										1972	— [9,12]
										1973	5,398[9]
										1974	5,203[9]
1974	45,881	22,023	65,669	5,812	8,797	2,985	2,755	594	6,334	1974	230[10]
										1975	7,986[10]
										1976	8,052[10]
										1977	4,255[10]
1976	47,519	22,809	110,507	9,780	12,865	3,085	2,848	638	6,571	1977	3,329[11]
Total Refunds Through December 31,										1977	$34,453
										1978	6,571[11]
Annual Ongoing Reduction in Excess of Normalization											$ 6,571

TABLE 2

Notes

General Telephone Company of California

Intrastate Operations

[1] Exhibit 2, Table 1, Columns (A), (B), and (D).

[2] Exhibit 2, Table 2, Normalization ÷ NTG (2.087 for T.Y. 1970 and 2.113 for T.Y. 1974 and 1976).

[3] Exhibit 6-A, Table 2-A, Column (B) ÷ NTG.

[4] Column (E) minus Column (D).

[5] Column (F) × .92037 [(F) × .48/1 — .48].

[6] Effects of state income tax and uncollectibles (.1645 × Col. (F) for T.Y. 1970, .1990 × Col. (F) for T.Y. 1974 and .20695 × Col. (F) for T.Y. 1976).

[7] (F) + (G) + (H).

[8] Column (I) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

[9] D.79367 rates effective 12-12-71 to 12-20-74.

[10] D.83779 rates effective 12-21-74 to 7-17-77.

[11] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[12] Adjustments for revenues not collected are shown on Table 7.

Appendix D

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TABLE 3

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

Test Year (Adjustment Year)	Investment Credit Realized [1]	Net Revenue Reduction: Service Life Flow-Through [2]	Net Revenue Reduction: Annual Adjustment [3]	Net Revenue Reduction: Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Service Life Flow-Through [7]	Refunds by Decision and Year's Rates Effective: Year	Refunds by Decision and Year's Rates Effective: Refund [8]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)
			(DOLLARS IN THOUSANDS)						
1973	$22,028	$ 3,249	$ 3,249	$ —	$ —	$ —	$ —	—	$ —
(1974)	24,901	3,249	4,805	1,556	1,437	60	3,053	1974	1,411[9]
(1975)	62,157	3,249	9,025	5,776	5,332	225	11,333	1975	13,302[9]
(1976)	65,983	3,249	13,315	10,066	9,291	392	19,749	1976	245[9]
1974-75	43,529[12]	6,915[12]	6,915[12]	—	—	—	—		
(1976)	65,983	6,915	13,315	6,400	5,907	275	12,582	1976	13,611[10]
(1977)	71,965	6,915	17,994	11,079	10,226	476	21,781	1977	22,662[10]
					Total Refunds Through December 31,			1977	$51,231
1975-76	64,070[12]	11,170[13]	11,170[12]	—	—	—	—		
(1977)	71,965	11,170[13]	17,994[13]	6,824	6,299	293	13,416	1978	23,346[11]
(1978)	77,683	11,170	23,045	11,875	10,960	511	23,346		
				Year 1978 Reduction in Excess of Service Life Flow-Through					$23,346

TABLE 3

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 10-A, Table 3, Column (A).

[2] Exhibit 10-A, Table 3, Column (D).

[3] Exhibit 10-A, Table 3, Column (D) in adjustment year.

[4] Column (C) minus Column (B). Note duplication of amounts for 1974, 1975, and 1976.

[5] Column (D) × .92307 [(D × .48/1 — .48].

[6] Effects of state income tax and uncollectibles (.039 × Col. (D) for T.Y. 1973 and .043 × Col .(D) for T.Y. 1974-75 and 1975-76).

[7] Columns (D) + (E) + (F).

[8] Column (G) adjusted as per Exhibit 40, Computation Method 2. Interest added at the rate of 7% per year for 1974-77.

[9] D.83162 rates effective 8-17-74 to 1-4-76.

[10] D.85287 rates effective 1-5-76. One-half 1977 included.

[11] A.55492 test year data adjusted to most recent estimates. 1978 reduction, Column (G).

[12] Average of two calendar years.

[13] Adjusted as 10/4 times amounts shown in Exhibit 10-A, Table 3 for 1977 in order to approximately reflect the 10% Investment Credit available under the Tax Reform Act of 1976.

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TABLE 4

GENERAL TELEPHONE COMPANY OF CALIFORNIA INTRASTATE OPERATIONS

COMPUTATION OF REFUNDS AND 1978 REVENUE REDUCTION DUE TO NEWLY ADOPTED TREATMENT OF TAX EXPENSE RELATED TO INVESTMENT TAX CREDIT

Test Year (Adjustment Year)	Investment Credit Realized [1]	Net Revenue Reduction — Service Life Flow-Through [2]	Net Revenue Reduction — Annual Adjustment [3]	Net Revenue Reduction — Additional Net Reduction [4]	Federal Income Tax Reduction [5]	Other Gross Revenue Effects [6]	Gross Revenue Reduction Over Service Life Flow-Through [7]	Refunds by Decision and Year's Rates Effective — Year	Refunds by Decision and Year's Rates Effective — Refund [8]
	(A)	(B)	(C)	(D) (DOLLARS IN THOUSANDS)	(E)	(F)	(G)	(H)	(I)
1970	—	—	—	—	—	—	—	—	—
(1971)	$ 2,802	$ —	$ 200	$ 200	$ 185	$ 33	$ 418	1971	$ — [9,13]
(1972)	5,119	—	420	420	388	69	877	1972	— [9,13]
(1973)	4,477	—	718	718	663	118	1,499	1973	1,520 [9,13]
(1974)	5,006	—	1,052	1,052	971	173	2,196	1974	2,664 [9]
1974	5,006	1,052	1,052	—	—	—	—	—	—
(1975)	9,845	1,052	1,708	656	605	131	1,392	1975	1,632 [10]
(1976)	12,267	1,052	2,526	1,474	1,360	294	3,128	1976	3,428 [10]
(1977)	20,093	1,052	3,866	2,814	2,597	561	5,972	1977	3,267 [10]
1976	12,267	2,526	2,526	—	—	—	—	—	—
(1977)	20,093 [12]	2,526 [12]	3,866 [12]	1,340	1,237	277	2,854	—	1,317 [11]
					Total Refunds Through December 31,			1977	$13,828
(1978)	13,495	2,526	4,766	2,240	2,067	464	4,771	1978	4,771 [11]
					Year 1978 Reduction in Excess of Service Life Flow-Through				4,771

TABLE 4

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA

INTRASTATE OPERATIONS

[1] Exhibit 2, Table 3, Column (A). Note duplication of amounts for 1974 and 1976.

[2] Exhibit 6, Table 3, Column (D).

[3] Exhibit 6, Table 3, Column (D) in adjustment year.

[4] Column (C) minus Column (B).

[5] Column (D) $\times$ .92307 [(D) $\times$ .48/1 — .48].

[6] Effects of state income tax and uncollectibles. (.1645 $\times$ Col. (D) for T.Y. 1970 and .1990 $\times$ Col. (D) for T.Y. 1974 and .20695 $\times$ Col. D for T.Y. 1976).

[7] Columns (D) + (E) + (F).

[8] Column (G) adjusted as per Exhibit 25, Table 8-A. Interest added at the rate of 7% per year for 1971-77.

[9] D.79367 rates effective 12-12-71 to 12-20-74.

[10] D.83779 rates effective 12-21-74 to 7-17-77.

[11] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[12] Adjusted as 10/4 times amounts shown in Exhibit 6, Table 3 for 1977 in order to approximately reflect the 10% investment credit under the Tax Reform Act of 1976.

[13] Adjustments for revenues not collected are shown on Table 7.

Appendix F

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TABLE 5

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1968 AND 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation—First Year		Additional Net Revenue Reduction Vintage Year 1968-1969 Additions [3]	Federal Income Tax Reduction [4]	Other Gross Revenue Effects [5]	Additional Gross Revenue Reduction [6]	Refunds by Decision and Year's Rates Effective	
	1970 [1]	1968 [2]					Year	Refund [7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1973	$43,131	$50,132	$7,001	$6,462	$273	$13,736	1974	$ 6,540[8]
							1975	17,415[8]
							1976	203[8]
1974-5	57,103	61,359	4,256	3,929	183	8,368	1976	9,616[9]
							1977	9,796[9]
			Total Refunds Through December 31,				1977	$43,570
1975-6	65,782	68,599	2,817	2,600	122	5,539	1978	5,539[10]
						Annual Ongoing Reduction		$ 5,539

TABLE 5

NOTES

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

INTRASTATE OPERATIONS

[1] Exhibit 32 in A.53587, Table II, Column (a), Tax Depreciation $\times$ 48%. For fiscal years, use average of calendar years.

[2] Exhibit 32 in A.53587, Table II-A, Column (a), Tax Depreciation $\times$ 48%. For fiscal years, use average of calendar years.

[3] Column (B) minus Column (A).

[4] Column (C) $\times$ .92307 ((C) $\times$ .48/1 — .48).

[5] Effects of state income tax and uncollectibles (.039 $\times$ Col. (C) for T.Y. 1973 and .043 $\times$ Col. (C) for T.Y. 1974-75 and 1975-76).

[6] (C) + (D) + (E).

[7] Col. (I) adjusted as per Exhibit 34, page 4 and Exhibit 41. Interest added at the rate of 7% per year for 1974-77.

[8] D.83162 rates effective 8-17-74 to 1-4-76.

[9] D.85287 rates effective 1-5-76.

[10] A.55492 test year data adjusted to most recent estimates.

[11] Average of two calendar years.

Appendix G

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TABLE 6

GENERAL TELEPHONE COMPANY OF CALIFORNIA INTRASTATE OPERATIONS

COMPUTATIONS OF REFUNDS AND ONGOING REVENUE REDUCTION DUE TO IMPUTED FLOW-THROUGH OF ACCELERATED TAX DEPRECIATION FOR VINTAGE YEAR 1969 PLANT ADDITIONS

Test Year	Federal Tax Effect of Accelerated Tax Depreciation—First Year		Additional Net Revenue Reduction	Federal Income Tax	Other Gross Revenue	Additional Gross Revenue	Refunds by Decision and Year's Rates Effective	
	1970 [1]	1969 [2]	Vintage Year 1969 Additions [3]	Reduction [4]	Effects [5]	Reduction [6]	Year	Refund [7]
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
			(DOLLARS IN THOUSANDS)					
1970	$ 1,811	$ 3,963	$2,152	$1,986	$353	$4,491	—	—
							1971	[8,11]
							1972	[8,11]
							1973	$ 2,015 [8,11]
							1974	7,229 [8]
1974	11,001	12,055	1,054	973	209	2,236	1974	81 [9]
							1975	2,819 [9]
							1976	2,843 [9]
							1977	1,502 [9]
1976	13,789	14,410	621	573	128	1,322	1977	670 [10]
				Total Refunds Through December 31,			1977	$17,159
							1978	1,311 [10]
						Annual Ongoing Reduction		$ 1,311

TABLE 6

NOTES

GENERAL TELEPHONE COMPANY OF CALIFORNIA

INTRASTATE OPERATIONS

[1] Exhibit 5-R in A.53935 and A.51904 Rehearing, Table I, Column (a) Tax Depreciation × 48% × intrastate factors of .891 for T.Y. 1970, .873 for T.Y. 1974, and .855 for T.Y. 1976.

[2] Exhibit 5-R, Table I-A, Column (a), Tax Depreciation × 48% × intrastate factors as in Footnote 1, above.

[3] Column (B) minus Column (A).

[4] Column (C) × .92307 ((C) × .48/1 — .48).

[5] Effects of state income tax and uncollectibles (.1645 × Col. (C) for T. Y. 1970, .1990 × Col. (C) for T.Y. 1974, and .20695 × Col. (C) for T.Y. 1976).

[6] (C) + (D) + (E).

[7] Column (H) adjusted as per Exhibit 25, Table A-A-2. Interest added at the rate of 7% per year for 1971-77.

[8] D.79367 rates effective 12-12-71 to 12-20-74.

[9] D.83779 rates effective 12-21-74 to 7-17-77.

[10] D.87505 rates effective 7-18-77. Test year data adjusted to most recent estimates.

[11] Adjustments for revenues not collected are shown on Table 7.

Appendix H

TABLE 7

GENERAL TELEPHONE COMPANY OF CALIFORNIA
INTRASTATE OPERATIONS

ADJUSTMENTS TO TABLES 2, 4, AND 6
FOR REVENUES NOT COLLECTED

Line No.	Item	Gross Revenue Reductions 12-12-71 to 12-31-71	1972	1-1-73 to 9-22-73
		(A)	(B)	(C)
		(Dollars in Thousands)		
1	Total Revenues Not Collected [1]	$ 846	$12,601	$4,372
2	Line 1 Adjusted to 12-31-77 Refund Levels [2]	1,313	18,889	5,963
	Refund Offset by Line 2			
3	Imputed Flow-Through	377	7,616	5,476
4	Investment Tax Credit	35	1,299	487
5	Liberalized Tax Depreciation	291	5,486	—
6	Remaining Revenues Not Collected [3]	393	2,994	—

[1] Exhibit 2, Table 6, line 15 (adjusted for D.83778 refunds).

[2] Adjusted by including interest to match refund amounts.

[3] Line 2, less lines 4, 5, and 6, divided by interest factor.

Commissioner Richard D. Gravelle, Concurring.

Commissioner Claire T. Dedrick, Concurring.

We concur.

Today's decision, while attributed to this Commission, is not really ours. We are merely the instrument of delivery. This decision was spawned by the Bell System; nurtured by Congress; brought through adolescence by the efforts of our staff, the cities of San Francisco, Los Angeles, San Diego, and TURN; shaped into maturity by the California Supreme Court; and finally left to us for mere refinement. The entity most responsible for the result of the order as it stands is the Court, which clearly mandated us to achieve a balance between utility and ratepayer which we have finally done. We have also protected eligibility by carefully remaining within the confines of the tax laws and regulations. No one, however, should be confused on the latter point. The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be.
San Francisco, California
September 13, 1977

/s/ Richard D. Gravelle
Richard D. Gravelle, Commissioner

/s/ Claire T. Dedrick, Commissioner
Claire T. Dedrick, Commissioner

Pacific Telephone & Telegraph Company

General Telephone Company of California

Re: Accelerated Depreciation and Investment Tax Credit

Commissioner William Symons, Jr., Dissenting

California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness.

Congress enacted the federal tax laws, and in order to qualify for specific federal tax benefits, it is realistic to expect that the intentions of Congress be respected. Eligibility under the federal tax laws makes it possible for the communication companies in California to use accelerated depreciation and to receive investment tax credit. To have the federal government forego the collection of these taxes is most beneficial to both the utilities and the ratepayers. To risk these tax benefits so needlessly is bad regulatory administration. Loss of eligibility through 1976 as a consequence of California Public Utilities Commission action means that Pacific Telephone will have to pay taxing authorities in Washington, D.C., retroactive tax bills of $764 million. General Telephone will have to pay $223 million. Loss of eligibility into the future will cost our communication system and ratepayers additional hundreds of millions of dollars in taxes.

I cannot support a decision which fails to take the opportunity to resolve the "eligibility" issue before the Commisson decision is finalized and "set in concrete". Assurance on the issue of eligibility is proceduraly feasible if we were to follow the recommendation of the Administrative Law Judge in this case. The order as originally drafted deferred any effective date until 180 days. This was done to allow the utilities a reasonable period to obtain a ruling on eli-

gibility from the U.S. Internal Revenue Service. Ratepayer interest would have been protected by adequate accounting, refund, and interest provisions.

But today's majority strikes out that simple safeguard. In doing so they ignore the fact that last year's schemes, which the majority recklessly imposed on the state's largest electric utility and the state's largest gas utility, are in grave danger of causing millions of dollars in unnecessary tax liabilities to fall upon those companies. (See Majority and Minority Opinions: A. 54946 *Southern California Edison Company,* D. 86794, December 21, 1976; rehearing based on adverse tax attorney opinion, D. 87828, September 7, 1977; and A. 55676, *Southern California Gas Company,* D. 85627, March 30, 1976, together with adverse IRS ruling, dated November 22, 1976; California Supreme Court decision pending, in Case SF 23495.)

In light of these danger signals, it is imprudent of the Commission not to exhaust available consultive procedures and thus safeguard the state against the catastrophic consequences of ineligibility.

Instead, the majority lectures Congress on legislative goals. Acting as a school marm to Congress, the majority tells the national legislature that federal tax credits and deferrals may be used to lower monthly utility bills, but may not be used to stimulate job development or accelerated capital investment. Such homey advice is interesting but what the California ratepayer will have to worry about is the bottom line. What will he and the California utility companies have to pay to Washington, D.C., after the IRS has cut through the verbiage of this decision and applied the law?

San Francisco, California

September 13, 1977

/s/ WILLIAM SYMONS, JR.
WILLIAM SYMONS, JR.

COMMISSIONER VERNON L. STURGEON, Dissenting

The inconsistent and cavalier manner in which the majority treats the key issue of eligibility for accelerated depreciation warrants my strong dissent. The majority recognizes, as it must, that our regulatory treatment of accelerated depreciation and the investment tax credit (ITC) *must* preserve General's and Pacific's eligibility for these tax saving methods. The majority, in one of its few realistic comments on the question, states that:

> "Eligibility is the first issue to be determined. To render a decision which attempts to resolve these cases without regard for this issue might create problems for these utilities, their ratepayers, the Commission, and the Courts that even exceed (both in scope and complexity) the problems that we are attempting to resolve in this decision." (Mimeo p. 19)

After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations *must* be considered a matter of speculation. While the majority states confidently (Finding No. 3) that "This method complies with Treasury Regulation 1.167(*l*)-(1)(h)(6) and is normalization accounting," they admit (at Mimeo p. 41) that "We have here a case of first impression under the tax laws . . ."

The Examiner's Proposed Report took a sensible approach to the eligibility question by setting an effective date 180 days after the entry of the order. Had a majority of the Commission had the wisdom to adopt such an approach, Pacific and General would have not only the time but the incentive to seek an expeditious IRS ruling. The majority correctly points that "expeditious" is not an adjective frequently associated with IRS rulings (as it is not with deci-

sions of this Commission). However, even if no such ruling were issued within the 180 days following the entry of the order, what harm would occur? Under the Examiner's approach, the order would simply be final at that time. If a ruling was issued, the Commission would then have the opportunity to modify the order if necessary.

It is doubtful that any of the majority would, in the handling of their own federal income taxes, make a decision involving a risk of substantial tax liability in which their position rested on a legal position which they knew to be a "case of first impression under the tax laws." Today, however, they have asked Pacific, General and their ratepayers to do just that.

/s/ VERNON L. STURGEON
VERNON L. STURGEON
Commissioner

San Francisco, California

September 13, 1977

APPENDIX C

APPENDIX C

Article VI of the Constitution:

> * * * This Constitution, and the laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding. * * *

The Fourteenth Amendment to the Constitution:

> * * * nor shall any State deprive any person of life, liberty or property, without due process of law * * * *

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 46. AMOUNT OF CREDIT.

* * * *

(f) [as amended by Sec. 105(c), Revenue Act of 1971, P.L. 92-178, 85 Stat. 503, Sec. 302(a), Tax Reduction Act of 1975, P.L. 94-12, 89 Stat. 40, and Sec. 1906(b)(13)(A), Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1834] LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is

applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, the immediately preceding sentence shall not apply to property described in paragraph (5)(B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5)(B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

(2) Special rule for ratable flow-through.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

(A) Cost of service reduction.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection), or

(B) Rate base reduction.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

* * * *

(4) Limitation.—

(A) In general.—The requirements of paragraphs (1), (2), and (9) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1), (2), or (9) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1), (2), or (9) (as the case may be) is put into effect, and

(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1), (2), or (9) (as the case may be) is put into effect.

(B) Determinations.—For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c)(3)(B) which determines the effect of the credit allowed by section 38 (determined without regard to this subsection)—

(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

(ii) in the case of a taxpayer which made an election under paragraph (2) or the election described in paragraph (9), on the taxpayer's cost of

service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

(C) SPECIAL RULES.—For purposes of this paragraph—

(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed.

(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

(iii) a subsequent determination is a determination subsequent to a final determination.

(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term "public utility property" means—

(A) property which is public utility property within the meaning of subsection (c)(3)(B), and

(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates of such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c)(3)(B).

(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another tax-

payer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

* * * *

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * *

(*l*) [as amended by Sec. 441(a), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 625, and Sec. 1906(b)(13)(A), Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1834] REASONABLE ALLOWANCE IN CASE OF PROPERTY OF CERTAIN UTILITIES.—

(1) PRE-1970 PUBLIC UTILITY PROPERTY.—

(A) IN GENERAL.—In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(i) a subsection (*l*) method, or

(ii) the applicable 1968 method for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of accounting.

(B) Flow-through method of accounting in certain cases.—In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if—

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.

(2) Post-1969 public utility property.—In the case of any post-1969 public utility property, the term "reasonable allowance" as used in subsection (a) means an allowance computed under—

(A) a subsection (*l*) method.

(B) a method otherwise allowable under this section if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method, if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.

(3) Definitions.—For purposes of this subsection—

(A) Public utility property.—The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(i) electrical energy, water, or sewage disposal services.

(ii) gas or steam through a local distribution system.

(iii) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U. S. C. 701), or

(iv) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(B) Pre-1970 public utility property.—The term "pre-1970 public utility property" means property which was public utility property in the hands of any person at any time before January 1, 1970.

(C) Post-1969 public utility property.—The term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(D) Applicable 1968 method.—The term "applicable 1968 method" means, with respect to any public utility property—

(i) the method of depreciation used on a return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) if clause (i) does not apply, the method used by the taxpayer on a return for the latest taxable year for which a return was filed before August 1, 1969, with respect to its public utility property of

same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service, or

(iii) if neither clause (i) nor (ii) applies, a subsection (*l*) method.

In the case of any section 1250 property to which subsection (j) applies, the term "applicable 1968 method" means the method permitted under subsection (j) which is most nearly comparable to the applicable 1968 method determined under the preceding sentence.

(E) Applicable 1968 method in certain cases.—If the taxpayer evidenced the intent to use a method of depreciation (other than its applicable 1968 method or a subsection (*l*) method) with respect to any public property in a timely application for change of accounting method filed before August 1, 1969, or in the computation of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 accounting period, such other method shall be deemed to be its applicable 1968 method with respect to such property and public utility property of the same (or similar) kind subsequently placed in service.

(F) Subsection (*l*) method.—The term "subsection (*l*) method" means any method determined by the Secretary to result in a reasonable allowance under subsection (a), other than (i) a declining balance method, (ii) the sum of the years-digits method, or (iii) any other method allowable solely by reason of the application of subsection (b)(4) or (j)(1)(C).

(G) Normalization method of accounting.—In order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation.

(H) Flow-through method of accounting.—The taxpayer used a "flow-through method of accounting" with respect to any public utility property if it used the same method of depreciation (other than a subsection (*l*) method) to compute its allowance for depreciation under this section and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

(I) July 1969 accounting period.—The term "July 1969 accounting period" means the taxpayer's latest accounting period ending before August 1, 1969, for which it computed its tax expense for purposes of reflecting operating results in its regulated books of account.

For purposes of this paragraph, different declining balance rates shall be treated as different methods of depreciation.

* * * *

(5) Reorganizations, assets acquisitions, etc.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business

of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.

(m) CLASS LIVES.—

(1) IN GENERAL.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term "reasonable allowance" as used in subsection (a) means (with respect to property which is placed in service during the taxable year and which is included in any class for which a class life has been prescribed) only an allowance based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The allowance so prescribed may (under regulations prescribed by the Secretary) permit a variance from any class life by not more than 20 percent (rounded to the nearest half year) of such life.

(2) CERTAIN FIRST-YEAR CONVENTIONS NOT PERMITTED.—No convention with respect to the time at which assets are deemed placed in service shall be permitted under this section which generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

(3) MAKING OF ELECTION.—An election under this subsection for any taxable year shall be made at such time, in such manner, and subject to such conditions as may be prescribed by the Secretary by regulations.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.167(*l*)-1. Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope.* Section 167(*l*) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to "public utility property" (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for "pre-1970 public utility property" and in paragraph (d) of this section for "post-1969 public utility property." Under section 167(*l*), a taxpayer may always use a straight line method (or other "subsection (*l*) method" as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (*l*) method is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a "normalization method of regulated accounting" (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (*l*) method is not prohibited by section 167(*l*) if the taxpayer used a "flow-through method of regulated accounting" described in paragraph (i) of this section) for its "July 1969 regulated accounting period" (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (*l*) method be used in the case of pre-1970 public utility property unless such method of depreciation is the "applicable 1968 method" (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(*l*) with respect to public utility property defined in section 167(*l*)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance

for depreciation under section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(*l*) do not pertain to other book-tax timing differences with respect to State income taxes, F. I. C. A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

*   *   *   *

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167(*l*), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(*a*) If the same method of depreciation (whether or not a subsection (*l*) method) is used to compute both its

tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(*b*) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (*a*) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(*l*)(1)(B) or (2)(C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's "qualified public utility property". See § 1.167(*l*)-2(b) for definition of "qualified public utility property".

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (*l*) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (*l*) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (*l*) method,

then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

* * * *

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under section 167(*l*) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any pro-

jected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974, for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(*l*)(2)(B) to use a method of depreciation other than a subsection (*l*) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within

a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(*l*) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example (2). Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(*l*) at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be

January	1-31	$ 310,000
February	1-28	300,000
March	1-31	300,000
April	1-30	280,000
May	1-31	270,000
June	1-30	260,000

July	1-31	260,000
August	1-31	250,000
September	1-30	240,000
		$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000	×	243/273	=	$ 275,934
300,000	×	215/273	=	236,264
300,000	×	184/273	=	202,198
280,000	×	154/273	=	157,949
270,000	×	123/273	=	121,648
260,000	×	93/273	=	88,571
260,000	×	62/273	=	59,048
250,000	×	31/273	=	28,388
240,000	×	1/273	=	879
				$1,170,879.

Example (3). Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and

that the reserve for deferred taxes under section 167(l) is \$1,300,000 for 1974 and is projected to be \$4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of \$145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base (\$145,000,000) greater than \$1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be

1st quarter	\$ 910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
	\$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is \$2,591,480 (the amount of the reserve at the beginning of the period (\$1,300,000) plus a pro rata portion (\$1,291,480) of the \$3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

\$910,000 ×	276/365 =	\$	688,110
810,000 ×	185/365 =		410,548
750,000 ×	93/365 =		191,096
630,000 ×	1/365 =		1,726
			\$1,291,480

APPENDIX D

APPENDIX D

INTERNAL REVENUE SERVICE DEPARTMENT OF THE TREASURY

Index Number 0167.23-00

Washington, DC 20224

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph
Company
140 New Montgomery Street
San Francisco, California 94105

Date: 8 June 1978

Taxpayer—Pacific Telephone & Telegraph Co.*

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision X—87838, September 13, 1977

Dear Mr. Dalenberg:

This replies to your ruling request dated September 29, 1977, as supplemented, the latest being dated May 3, 1978, and filed on your behalf by your representatives concerning your company (taxpayer).

You request a ruling that should Decision No. X of the Commission, dated September 13, 1977, become final, will the taxpayer remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; 2) depreciation based on Class Lives Asset Depreciation

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* The comparable ruling issued to General is printed in this Appendix, *infra*, pp. 116A-131A.

Range (CLADR) system for post-1970 public utility property; 3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and 4) the investment tax credit?

Taxpayer is a state corporation and is a subsidiary of its parent, which has its principal place of business at 195 Broadway, New York, New York 10007. Taxpayer is subject to regulation by the Commission with respect to its intrastate rates and services. It is a member of a group of affiliated corporations which files consolidated Federal income tax returns under section 1501 of the Code.

By letter dated December 22, 1977, you have formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. Based on your request, we are replying to the first three issues in this ruling letter and will reply to the investment tax credit issues at a later date.

Several state utilities, taxpayer not being one of them, elected accelerated depreciation in the 1950's and chose to establish a reserve on their books of account and for ratemaking purposes for the deferred taxes. This was a normalization method of accounting.

In 1960 the Commission determined that the flow-through method of accounting was to be used in setting rates for utilities using accelerated depreciation for tax purposes. Taxpayer did not elect the accelerated method of depreciation, but chose to remain on the straight line method for tax purposes (until 1970) and in computing depreciation expense in its regulated books of account. Thus, taxpayer used a straight line method of depreciation for both its regulated books of account and for tax purposes for its pre-1970 public utility property.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 public utility property. Pursuant to section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations, the taxpayer has normalized, based on

straight line depreciation, the difference between the longer book lives (to compute depreciation for book purposes) and the shorter CL system lives (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

Pursuant to the Tax Reform Act of 1969, the taxpayer made a timely election to use accelerated depreciation to compute depreciation expense for determining its Federal income tax, beginning with its 1970 tax return and used the normalization method of accounting. Therefore, taxpayer in using an accelerated method of depreciation with respect to its post-1969 public utility property. As taxpayer was using the straight line method of depreciation, as provided under section 167(*l*)(1)(A) of the Code, for tax purposes on August 1, 1969, it was not eligible to use the flow-through method of accounting.

Taxpayer has made a timely election to use the CLADR system for its post-1970 public utility property. Pursuant to section 1.167(a)-11(b)(6)(ii) of the regulations, the taxpayer has normalized the difference between the book lives (to compute depreciation for book purposes) and the power limit of the appropriate asset guideline range (to compute depreciation for actual tax purposes). The deferred tax amount is placed in a reserve account that is deducted from the adjusted rate base in the computation of the taxpayer's cost of service for ratemaking purposes.

The Commission issued a decision on November 6, 1968, concerning taxpayer, establishing rates by reducing taxpayer's tax expense for the test year 1967 as though it had used accelerated depreciation on its 1967 tax return. By computing accelerated depreciation with flow-through, the Commission gave the ratepayers the benefit of a tax deferral which the taxpayer did not actually realize. With the taxpayer's announced use of accelerated depreciation the

Commission issued an interim decision on November 24, 1970, holding that taxpayer's rates would be established to reflect its use of accelerated depreciation and the normalization method of accounting. On June 22, 1971, the Commission granted a rate increase to taxpayer based on the interim decision.

On November 26, 1971, the state Supreme Court annulled the interim decision of November 24, 1970, holding that the Commission had erred in failing to consider lawful alternatives to normalization. The court ruled that imputed accelerated depreciation with flow-through was a lawful alternative, but remanded to the Commission for consideration of all alternatives, including normalization and any compromise between normalization and imputed accelerated depreciation with flow-through. The court then annulled the Commission's June 22, 1971 decision and ordered the Commission to reinstate the rates established in the 1968 decision. On July 23, 1974, the Commission issued a decision granting taxpayer a rate increase based on accelerated depreciation with normalization. The Commission adopted normalization to preserve the taxpayer's eligibility for accelerated depreciation.

On December 12, 1975, the court annulled that part of the Commission's 1974 order relating to the treatment of tax expense, resulting from the use of accelerated depreciation, principally because the court disagred with the Commission's conclusion that it had no regulatory authority to consider alternate methods of treating the accelerated depreciation. The court remanded for further proceeding relating to tax expense.

Following additional hearings, the Commission issued Decision X on September 13, 1977. This decision covers the tax issues in three separate rate cases using test periods for: 1) calendar year 1973; 2) fiscal year 7/1/74-6/30/75 and; 3) fiscal year 7/1/75-6/30/76. The Commission ordered the taxpayer to make refunds and annual reductions in rates with respect to these cases.

It seems the Commission had the view that full flow-through of the tax deferral resulting from using accelerated depreciation was the proper and best ratemaking method, but could not consider it as the taxpayer was not eligible for this method of accounting, since taxpayer was using straight line depreciation on August 1, 1969.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed an "average annual adjustment method." In its presentation of this method, the Commission has attempted to take into account section 1.167(*l*)-1(h)(6) of the regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes.

Decision No. X states that the theory of the method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjusted for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses the taxpayer's actual reserve for deferred taxes for the years 1973, 1974 and 1975, and estimated plant additions for the succeeding three years of each test year and computed the estimated reserve for deferred taxes for these years. The simple average of the average annual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property for the four year period was deducted from the rate base, that was adjusted for the test year depreciation reserve, but not for the additional estimated depreciation reserve for the succeeding three years.

As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this amount from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income was then substituted in the cost of service for the larger test year net operating income figure and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the larger test year tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The Commission believes the taxes set aside in the deferred tax reserve shall never be paid and amounts to a tax savings rather than a tax deferral. The depreciation expense, included in the cost of service, was left undisturbed.

The Commission believes the normalization method of accounting does not approach the only sensible and realistic method of setting rates, that is, using the actual tax expense as the cost of service tax expense. It believes their annual average adjustment adopted in its Decision No. X "is a more equitable and realistic method of normalization than the other proposals and the best available now."

Decision No. X states that the actual Federal tax expense bears no direct relation to the increase in deferred tax reserve, but fluctuates independently of it and cites an exhibit submitted by the taxpayer in a rate case. It believes that the Code or regulations thereunder do not discuss the estimating process and believes that this method uses the same time period for estimating the reserve for deferred taxes and the tax expense for establishing cost of service for ratemaking purposes; and that section 1.167(*l*)-1(h)(6) of the regulations is satisfied and eligibility is maintained for

accelerated depreciation, CLADR system and the CL system.

In reviewing the taxpayer's record in the proceedings, it came to the attention of the Commission that for the 1968 and 1969 vintage plant additions no accelerated depreciation was ever reflected in taxpayer's rates. In a previous application of taxpayer, imputed flow-through was proposed for the 1968 and 1969 vintage accounts. Decision No. X adopted this imputed flow-through for these years and used it to determine tax expense in each of the three taxpayer's test year cost of services for ratemaking purposes to compute the reduction in rates and the amount of the refund.

The taxpayer became concerned when the Commission's Decision No. X was issued and therefore requested the present ruling to determine whether the decision would impair its eligibility for accelerated depreciation, use of CLADR system under section 1.167(a)-11 of the regulations and the CL system under section 1.167(a)-12. If the decision becomes final and is inconsistent with the Code and regulations thereunder, taxpayer stated it will have enormous Federal tax obligations for both past and future years. The request for this ruling is the result of the Commission's decision.

The taxpayer states it is following the normalization method of accounting in regard to accelerated depreciation under section 167(*l*) of the Code and adhering to the normalization of tax deferrals resulting from the use of shorter lives for tax purposes than are used for regulatory purposes to comply with section 1.167(a)-11(b)(6)(ii) of the regulations for post-1970 public utility property CLADR system and section 1.167(a)-12(a)(4)(iii) for pre-1971 public utility property CL system.

It is the taxpayer's belief that the average annual adjustment method is the same as the method proposed by the Commission's staff several years ago and rejected by the

Commission as being inconsistent with section 167(l) of the Code and regulations thereunder. The taxpayer states that the simple average of the reserve for deferred taxes that is excluded from the rate base is greater than the amount of the reserve for deferred taxes excluded from the test year rate base. Therefore, the exclusion of a larger deferred tax reserve covering a different time period than the time period used in determining tax expense for cost of service purposes is precisely what section 1.167(l)-1(h)(6) of the regulations prohibits.

The taxpayer further states that when a computation is made of net revenue reduction, it has a bearing on tax expense because of the necessary mathematical relationship between after-tax net revenues and Federal income taxes. The taxpayer believes the Commission's computation is not how the tax expense under section 1.167(l)-1(h)(6)(i) of the regulations should be computed, otherwise this section of the regulations would have no meaning as far as the amount of the reserve for deferred taxes to be deducted from the rate base is concerned. The taxpayer believes the tax expense as computed under the average annual adjustment method does not represent actual or a proper estimated tax expense for the test year, any future year, or any average of these years.

The taxpayer is also concerned about the Commission's use of the actual reserve for deferred taxes being used for the calendar years 1973, 1974 and 1975, while using estimated figures for all other cost of service items, including tax expense. The deferred tax reserve figures for each of the test years were substantially higher than the original estimated figures, as more property was placed in service than originally estimated.

Should the Commission amend its decision to eliminate the four-year forward averaging of the reserve for deferred taxes, the taxpayer states the deferred portion of normalized tax expense included in the cost of service for each test year would still be equal to the lower estimated figure, while the deferred portion of the normalized tax expense excluded from the rate base would be equal to the higher actual figure. Therefore, the taxpayer believes the amount credited to the reserve and excluded from the rate base should be based on the deferred portion of the tax expense as stated under sections 1.167(l)-1(h)(1)(i) and (iii) of the regulations. The taxpayer further states that if the larger actual amount of the reserve is excluded from the rate base then the actual tax expense must be included in the cost of service for ratemaking purposes, otherwise the exclusion of the larger actual amount of the reserve for deferred taxes, without the use of the actual tax expense, would be in violation of section 1.167(l)-1(h)(6).

In regard to the question of being eligible for the continued use of accelerated method of depreciation for its post-1969 public utility property when the Commission has ordered imputed flow-through treatment with respect to the taxpayer's 1968 and 1969 vintage accounts, taxpayer states that it computes depreciation allowance for its 1968 and 1969 vintage accounts for both its regulated books of account and tax purposes on the straight line method in accordance with section 167(l)(1)(A) of the Code. Also, the imputed flow-through method of accounting for the 1968 and 1969 vintage accounts does not prevent the use of the accelerated methods of depreciation for its post-1969 public utility property. The taxpayer cites section 1.167(l)-1(d)(2)(ii) of the regulations, and believes that the phrase, "with respect to the property" means the normalization requirements with respect to the property on which accelerated depreciation is claimed. The taxpayer believes the normalization method of accounting need not be followed for all property as a condition to using accelerated depreciation for post-1969 public utility property.

In regard to the question of being eligible to continue the use of the CL system for pre-1971 property, the taxpayer states the Commission's treatment of the 1968 and 1969

vintage accounts relates only to accelerated depreciation and does not reflect any adjustment of the shorter lives for the property under the CL system than are being used in computing tax expense and depreciation expense in the cost of service for ratemaking purposes. The taxpayer therefore believes the Commission's imputed flow-through of accelerated depreciation for the 1968 and 1969 vintage accounts does not impair its eligibility to use the CL system with respect to these vintage accounts.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167(*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-11(a)(1) of the regulations provides an optional election of an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970.

Section 1.167(a)-11(b)(6)(ii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating result in its regulated books of account. The normalization method of accounting shall have the same definition as stated in sections 167(*l*)(3)(G) of the Code and 1.167(*l*)-1(h).

Section 1.167(a)-11(b)(6)(iii) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(a)-12(a) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. This applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property, for which no guideline life was prescribed in Rev. Proc. 62-21, shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting

shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (*l*) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(*l*)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(*l*)-1(d)(2)(ii) of the regulations provides that under section 167(*l*)(2) of the Code, in the case of post-1969 public utility property, the term "reasonable allowance" means a subsection (*l*) method or a method of depreciation otherwise allowable under section 167 if with respect to the property the taxpayer uses a normalization method of regulated accounting.

Section 1.167(*l*)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(*l*)(3)(G) of the Code.

Section 1.167(*l*)-1(h)(2) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(*l*)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (*l*) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public property.

Section 1.167(*l*)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(*l*)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of

any projected increase to be credited or decreased to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of that period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flowing-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(l) of the Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1,

1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so, unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permits it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The question presented whether the taxpayer will remain eligible for: (1) accelerated depreciation under section 167(l) of the Code; (2) depreciation based on the CLADR system for post-1970 public utility property; and (3) depreciation based on CL system for pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(l)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking pur-

poses was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167(*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years 1973, 1974 and 1975 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

The election of the CLADR system under section 1.167(a)-11(b)(6)(ii) of the regulations, pertaining to post-1970 public utility property, and the continued elective use of this system are conditioned upon the taxpayer following the normalization method of accounting as provided under section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1

(h)(1)(i). We believe the reserve for deferred taxes that is determined over the test year and the succeeding three year period, and includes the tax deferral as determined under section 1.167(a)-11(b)(6)(iii) that is deducted from the rate base, exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

The election of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system, is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period, that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-11(b)(6)(iii) of the regulations pertaining to the elective use of the CLADR system, and under section 1.167(a)-12(a)(4)(iii) pertaining to the elective use the CL system, will result in the termination of the election of the CLADR system and the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

There is a question in regard to the treatment of the Commission's imputed flow-through of the 1968 and 1969 vintage plant additions to determine tax expense for the three test years to establish the cost of service for ratemaking purposes and whether such treatment conflicts with taxpayer's eligibility to use accelerated depreciation and the normalization method of accounting with respect to its post-1969 public utility property. The Tax Reform Act of 1969 recognized such a problem existed. To remedy this trend to accelerated depreciation and flow-through whether

imputed, or otherwise, Congress froze the situation as of August 1, 1969, regarding methods of depreciation by enacting section 167(*l*) of the Code. Implementing regulations were published. Regardless of what went on before this date if the public utility used straight line depreciation for its pre-1970 public utility property, it would make a timely election to apply accelerated depreciation to its post-1969 public utility property, provided it uses the normalization method of accounting. The taxpayer in this case made a timely election to apply accelerated depreciation to his post-1969 public utility property in accordance with section 167(*l*)(2)(B) of the Code and section 1.167(*l*)-1(d)(2)(ii) of the regulations. The continued use of accelerated depreciation is dependent upon the taxpayer following the normalization method of accounting as to its post-1969 public utility property and is not affected by the Commission's use of imputed flow-through as to pre-1970 vintage plant additions.

There also is a question in regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1968 and 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions. The use of the CL system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The Commission's use of imputed flow-through for the 1968 and 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

A schedule submitted by the taxpayer, dated March 7, 1978, showed that its depreciation expense, Federal income tax expense (normalized), average rate base and average reserve for deferred taxes increased, along with the addition of plant facilities over a period of 5 years (1973-1977 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the

form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153, it states that taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(1)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation. Additionally, the Commission's imputed flow-through of the 1968 and 1969 vintage plant

additions will not be cause for the taxpayer being ineligible to use an accelerated method of depreciation along with the proper normalization method of accounting as to its post-1969 public utility property. The taxpayer made a timely election to use an accelerated method of depreciation and the election is applicable only to its post-1969 public utility property.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe that it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount as permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on CLADR system property and the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of both the CLADR system and the CL system at the begin-

ning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1968 and 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii) of the regulations.

Very truly yours,

/s/ Geoffrey J. Taylor
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

INTERNAL REVENUE SERVICE Department of the Treasury
Index Number 0167.23-00 Washington, DC 20224
Mr. A. M. Hart
General Telephone Company
of California
100 Wilshire Boulevard
Santa Monica, California 90401

Date: 9 June 1978

Taxpayer—General Telephone Company of California

State—California

Commission—California Public Utility Commission

Parent—General Telephone & Electronics Corporation

Representatives—Covington & Burling

Decision X—87838—September 13, 1977

Dear Mr. Hart:

This replies to a ruling request, dated September 29, 1977, as supplemented, the latest being dated April 21, 1978, filed on your behalf by your representatives.

You request a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(*l*) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit if Decision No. X of the Commission, dated September 13, 1977 becomes final?

Taxpayer is a wholly owned subsidiary. The principal offices of its Parent are at One Stamford Forum, Stamford, Connecticut 06940. Taxpayer is principally engaged in the business of providing telephone service to residential, commercial, and industrial customers within the state of its incorporation, and its intrastate rates are regulated by the Commission of that state.

By letter dated January 24, 1978 you stated that you are concerned with a timely response to the issues concerning accelerated depreciation under section 167(*l*) of the Internal Revenue Code of 1954 and the CL system with respect to pre-1971 property. You ask that the ruling request be treated as two separate ones, with the response to the two depreciation issues first, and the response to the investment credit issue at a later date. In compliance with that request, we are ruling on the first two issues in this ruling letter and will reply to the investment tax credit issue at a later date.

In 1960 the Commission determined that the flow-through method of accounting was mandatory for utilities electing accelerated depreciation for tax purposes. The election of accelerated depreciation was left to the utility companies and taxpayer remained on straight line depreciation for tax purposes through 1969.

For its pre-1970 public utility property taxpayer used straight line depreciation for computing both its tax expense and depreciation expense for establishing its cost of service for ratemaking purposes, in its regulated books of account, and for actual tax purposes.

After August 1, 1969, the taxpayer, in accordance with the Tax Reform Act of 1969, made a timely election to use accelerated depreciation for its post-1969 public utility property. It was permitted to do so by the Commission and to normalize the deferred taxes beginning with the year 1970.

The proceedings that resulted in Decision No. X, followed the remand by the State Supreme Court in *City of Los Angeles* v. *Public Utilities Commission* (1975) 15 C 3d 680, which annulled that portion of the rate increase granted another public utility and taxpayer, relating to accelerated depreciation and investment tax credit. In the remand of the case the court held that the Commission has the power to implement an alternative method, one that involves an annual adjustment of the tax expense treatment for acceler-

ated depreciation and investment tax credit. The timely election by the taxpayer of accelerated depreciation, commencing with its taxable year 1970, led to the proceedings in which the Commission in its Decision No. X has attempted to comply with the mandate from the court to reach an equitable determination of the election of accelerated depreciation. In its presentation of the "average annual adjustment method," the Commission has attempted to take into account section 1.167(l)-1(h)(6) of the Income Tax Regulations so as to allow the taxpayer to maintain the election of accelerated depreciation for tax purposes. The taxpayer has before the Commission three rate cases using calendar year test periods 1970, 1974 and 1976.

It seems that the Commission viewed the full flow-through as being the proper and best ratemaking method, but since the taxpayer was not using an accelerated method of depreciation on August 1, 1969, flow-through could not be required.

The Commission had previously taken into account the reduced risk accompanying the election of the normalization method of accounting in determining taxpayer's rate of return. The Commission believed it would be unfair to reflect the reduced rate twice in the rate of return and, therefore, proposed the "average annual adjustment method."

Decision No. X states that the theory of this method is that because the increase in the deferred tax reserve is deducted from the rate base, the authorized rate of return on the smaller rate base produces less revenue. The smaller amount of net revenue will then produce less tax expense, since the taxable income will be decreased. Essentially, the total of the reduction in net revenues and the decreased tax expense, together with the adjustment for uncollectibles, amounts to the total gross revenue reductions.

In setting rates the Commission's method uses actual deferred tax amounts through 1976 and estimated amounts thereafter. This method consists of taking the simple average of the average annual reserve for deferred tax for both pre-1970 public utility property and post-1969 public utility property for the four year period and deducting this amount from the rate base, adjusted for the test year depreciation reserve, but not for the additional depreciation reserve for the succeeding three years. As this computed reserve for deferred taxes was larger than the test year figure, the subtraction of this deferred tax reserve from the rate base resulted in a rate base that was less than the test year rate base. The taxpayer's authorized rate of return was then applied to the reduced rate base to compute the reduced net operating income. This reduced net operating income figure was then substituted in the cost of service for the larger net operating income figure of the test year and certain net-to-gross multipliers were applied to the reduced net operating income to compute the reduced tax expense and reduced gross revenues. The reduced tax expense was then substituted in the cost of service for the test year's larger tax expense for ratemaking purposes. Because of this lower overall cost of service for ratemaking purposes, the rates that taxpayer charged its customers are now subject to refund and rate reduction. The depreciation expense, included in the cost of service, was left undisturbed.

Decision No. X states that pertinent sections of the Internal Revenue Code and regulations thereunder do not discuss the estimating process. Apparently, the Commission is of the view the method set forth in its decision uses the same time period for estimating both the reserve for deferred taxes and the tax expense for cost of service for ratemaking purposes; that section 1.167(l)-1(h)(6) of the regulations is satisfied; and eligibility for accelerated depreciation is maintained because while the method is different, the principle is identical to the ordinary test year principle. The Commission seems to take the view that the taxes set aside in the reserve for deferred tax account will never be paid and thus will amount to an actual tax savings rather than a tax deferral.

In reviewing the record of the taxpayer's proceedings it came to the attention of the Commission that 1969 vintage plant additions were not previously considered in the rate-making process. Decision No. X therefore included the 1969 vintage accounts in the ratemaking process by imputing flow-through of accelerated depreciation for that property.

In a previous Commission decision, it imputed flow-through of accelerated depreciation for taxpayer for its 1968 vintage plant using a 1968 test year. In a later decision, the Commission ordered increased rates using the normalization method of accounting for the accelerated depreciation beginning with 1970 vintage plant additions. The 1969 vintage plant additions never were reflected in taxpayer's rates. Imputed accelerated depreciation and flow-through was proposed by the Commission for the 1969 vintage plant additions and adopted in Decision No. X and continued through tests years 1970, 1974 and 1976.

Taxpayer made a timely election to claim depreciation under the CL system for its pre-1971 property for taxable years beginning with the year 1971, and has consistently used the straight line method of depreciation for both book and tax purposes for the 1969 vintage accounts and prior year accounts.

The taxpayer cites sections 1.167(*l*)-1(a)(1) and (2) and 1.167(*l*)-1(h)(6) of the regulations, and states that these regulations mandate synchronization of the reserve for deferred taxes that is deducted from the rate base with the corresponding tax expense that is included in the cost of service. It also states that, in accordance with section 1.167(*l*)-1(a)(1) the reserve for deferred taxes is to be increased only by the excess accelerated depreciation over the depreciation used in computing both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes.

The Commission had stated that based on an exhibit submitted by the taxpayer in a rate case, the actual Federal

tax expense bears no direct relation to the increase in deferred tax reserve but fluctuates independently of it. The taxpayer states that the figures in this exhibit need to be adjusted for straight line depreciation and investment tax credit to portray normalized tax expense. A table was submitted by taxpayer showing that actual increased plant additions resulted in additional revenues, Federal income tax expense, and net operating income over a period of seven years.

The taxpayer believes that since the increased depreciation accruing from the estimated plant additions has not been used to compute the depreciation expense included in the cost of service for ratemaking purposes, the estimated reserve for deferred taxes does not exist and there can be no additional exclusion from the rate base. The taxpayer also states the Commission's average annual adjustment method would require more than a permissible deduction of the reserve for deferred taxes from the rate base and the taxpayer would not be permitted to use an accelerated method of depreciation.

In regard to the election of the CL system, taxpayer states that, in conformity with section 1.167(a)-12(a)(4)(iii) of the regulations, and using straight line depreciation, it has normalized the difference in depreciation between that which is based on the longer lives used for book purposes and that which is based on the shorter CL system lives used to compute depreciation for actual tax purposes.

The taxpayer states it has never used accelerated depreciation for its 1969 vintage plant additions. Thus, the deferred tax reserve required to be flowed-through by the Commission's imputed accelerated method of depreciation does not actually exist on taxpayer's books. Taxpayer states that the flow-through is a purely hypothetical deferred tax reserve that would have developed by reason of the difference between the fictional tax based on accelerated depreciation and the actual amount of tax paid based on straight line depreciation.

The taxpayer has normalized and will continue to normalize all tax deferrals resulting from the election of the CL system.

The taxpayer believes that if a taxpayer who is required to normalize with respect to qualified public utility property fails to normalize, the election to apply class lives shall terminate as of the beginning of the tax year for which the taxpayer fails to normalize. Taxpayer believes that since Decision No. X imputed flow-through with respect to its 1969 vintage plant additions beginning in 1970, it will not be entitled to use class lives for such property for any year.

Section 167(*l*)(1)(A) of the Code provides that in regard to pre-1970 public utility property, the term "reasonable allowance" means: (i) a subsection (*l*) method or; (ii) the applicable 1968 method for such property.

Section 167 (*l*)(2)(B) of the Code provides that the taxpayer may use an accelerated method of depreciation if it uses a normalization method of accounting.

Section 167(*l*)(3)(G) of the Code provides that to use a normalization method of accounting with respect to public utility property, the taxpayer must use the same method of depreciation to compute both its tax expense and depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account. It then has to use, for computation of its Federal income tax liability, a method of depreciation other than that used for tax expense and depreciation expense and to make adjustments to a reserve to reflect the deferral of taxes resulting from the use of these different methods of depreciation.

Section 167(*l*)(3)(H) of the Code provides that to use a flow-through method of accounting with respect to any public utility property, the taxpayer must use the same method of depreciation, (other than a subsection (*l*) method), to compute its Federal income tax liability and to

compute its tax expense for purposes of reflecting operating results in its regulated books of account.

Section 1.167(a)-12(a)(1) of the regulations provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970 and applies to assets placed in service before January 1, 1971.

Section 1.167(a)-12(a)(4)(iii) of the regulations provides that, for purposes of normalization, a taxpayer that has public utility property for which no guideline life was prescribed in Rev. Proc. 62-21 shall use the period for depreciation for computing tax expense for ratemaking purposes and in its regulated books of account, that is, the period for computing the depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account. The normalization method of accounting shall have the same definition as stated in section 167(*l*)(3)(G) of the Code and section 1.67(*l*)-1(h).

Section 1.167(a)-12(a)(4)(iii)(c) of the regulations provides that if a taxpayer fails to normalize the tax deferral, the election to apply the CL system shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize the tax deferral.

Section 1.167(*l*)-1(a)(1) of the regulations provides that the use of a method of depreciation other than a subsection (1) method (which includes the straight line method) is not prohibited by section 167(*l*) for any taxpayer if the taxpayer uses a normalization method of regulated accounting. This section also states that the normalization method of accounting with respect to public utility property pertains only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 of the Code and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of service and for reflecting

operating results in the regulated books of account. This section of the regulations also provides that under section 1.167(l)-1(h)(6), the same time period is used to determine, for cost of service purposes, the amount of the deferred tax reserve resulting from the use of an accelerated method of depreciation and the reserve amount that may be excluded from the rate base in determining the cost of service.

Section 1.167(l)-1(h)(1)(i) of the regulations describes the normalization method of accounting, such as was described under section 167(l)(3)(G) of the Code.

Section 1.167(l)-1(h)(2)(i) of the regulations provides that when a taxpayer uses a normalization method of accounting he must credit the amount of deferred Federal income tax to a reserve for deferred taxes.

Section 1.167(l)-1(h)(4)(ii) of the regulations provides that where a taxpayer did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer who uses a subsection (l) method to compute its depreciation under section 167(a) of the Code and to compute its tax expense for reflecting operating results in its regulated books of account) it will be presumed that the taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property.

Section 1.167(l)-1(h)(6)(i) of the regulations provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the rate base to which the taxpayer's rate of return is applied exceeds the amount of such reserves for deferred taxes for the period used in determining the taxpayer's tax expense in computing the cost of service for ratemaking purposes.

Section 1.167(l)-1(h)(6)(ii) of the regulations provides that the amount of reserve that may be excluded from the rate base when an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, is the amount at the end of the historical period. When a future period is used to determine the amount to be excluded, then it is the amount at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future period. If the amount of reserve to be excluded is to be made by reference to both an historical period and a future portion of a period, then the amount of the reserve to be excluded from the rate base for the whole period is the amount at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the reserve account during the future portion of the period.

The Tax Reform Act of 1969 (1969-3 C.B. 423, 532) changed for tax purposes the method of treatment of accelerated depreciation allowed regulated utilities. Prior to this Act there were an increasing number of regulated utilities shifting from straight line depreciation to accelerated depreciation. At the same time regulatory agencies, which had previously permitted the tax deferrals to be normalized, tended to require the flow-through to the customers of the tax deferrals resulting from the use of accelerated depreciation. Later, several regulatory agencies imputed accelerated depreciation in determining the Federal tax expense of certain public utilities and flowed-through the resultant fictional tax deferrals, even though the utility was using straight line depreciation and was paying the greater amount of Federal income tax resulting from the use of the straight line method of depreciation.

Congress "froze" the situation as of August 1, 1969 regarding methods of depreciation by enacting 167(l) of the

Code. The 1969 Act applied the following rules for depreciation in the case of existing property.

1. If straight line depreciation was being taken as of August 1, 1969, then no faster depreciation is permitted as to that property.

2. If the taxpayer was taking accelerated depreciation and was "normalizing" its deferred taxes, as of August 1, 1969, then it must shift to the straight line method unless it continues to normalize as to that property.

3. If the taxpayer was taking accelerated depreciation and flowing-through the benefits of the deferred taxes to its customers as of August 1, 1969, then the taxpayer would continue to do so unless the appropriate regulatory agency permits a change to normalize as to that property.

In the case of new property placed in service after 1969, if the taxpayer was flowing-through to its customers the benefits of deferred taxes, then it would stay on accelerated depreciation and flow-through unless the regulatory agency permitted it to change to normalization. In all other cases accelerated depreciation is permitted only if the taxpayer normalizes the deferred taxes. The taxpayer is also permitted to elect straight line depreciation as to this new property.

The questions presented, whether the taxpayer will remain eligible for: 1) accelerated depreciation under section 167(*l*) of the Code and 2) depreciation based on the CL system with respect to the pre-1971 public utility property cannot be answered until it is determined whether the average annual adjustment method required by the Commission is a proper normalization method of accounting as defined by section 1.167(*l*)-1(h)(1)(i) of the regulations.

Under the Commission's average annual adjustment method, which takes into consideration both pre-1970 public utility property and post-1969 public utility property, the additional reserve for deferred taxes determined over the three years succeeding each test year was not computed by using the same method of depreciation as was used for the tax expense for purposes of establishing cost of service for ratemaking purposes. The decreased tax expense that was substituted in the cost of service for ratemaking purposes was computed by applying a net-to-gross multiplier to the recomputed net operating income. We believe this method of computing tax expense is in conflict with sections 1.167 (*l*)-1(h)(1)(i) and 1.167(*l*)-1(h)(4)(ii) of the regulations and is not considered a proper normalization method of accounting.

Further, the deduction from the rate base of the simple average of the test year and the succeeding three year estimated and actual reserve for deferred taxes for both pre-1970 public utility property and post-1969 public utility property exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6)(i) of the regulations, described in section 1.167(*l*)-1(h)(6)(ii), and the examples set forth in section 1.167(*l*)-1(h)(6)(iv).

The Commission established rates with respect to each of the three test years using actual deferred tax reserve figures for the years through 1976 to determine the amount of the exclusion from the rate base under its average annual adjustment method while all related factors were frozen at the estimated levels. We believe that the use of the actual deferred tax reserve in conjunction with the estimated tax expense is inconsistent with sections 1.167(*l*)-1(h)(1)(i), (iii) and 1.167(*l*)-1(h)(2)(i) of the regulations. Under these sections of the regulations the reserve for deferred taxes that is deducted from the adjusted rate base has to be the same deferred portion of the tax expense as described in these sections of the regulations. If such consistency is

absent, the exclusion of the actual reserve will be prohibited by section 1.167(*l*)-1(h)(6)(i).

In regard to the Commission's imputed flow-through of accelerated depreciation with respect to the 1969 vintage plant additions affecting taxpayer's continued eligibility to use the CL system for these plant additions, the use of this system under section 1.167(a)-12(a)(4)(iii) of the regulations is only concerned with the normalization of the tax deferral resulting from the use of the shorter lives under this system. The imputed flow-through of accelerated depreciation for the 1969 vintage plant additions does not affect the normalization of the tax deferral under the CL system.

The election of the CL system under section 1.167(a)-12 (a)(4)(iii) of the regulations pertaining to pre-1971 public utility property, and the continued elective use of this system is conditioned upon the taxpayer following the normalization method of accounting within the meaning of section 167(*l*)(3)(G) of the Code and section 1.167(*l*)-1(h)(1)(i). We believe the entire reserve for deferred taxes that is determined over the test year and the succeeding three year period that also includes the tax deferral as determined under section 1.167(a)-12(a)(4)(iii) exceeds the permissible exclusion from the rate base as allowed under section 1.167(*l*)-1(h)(6).

Failure to normalize properly the deferral of the tax expense as determined under section 1.167(a)-12(a)(4)(iii) of the regulations pertaining to the elective use the CL system will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to properly normalize the tax deferral.

A schedule submitted by taxpayer, dated September 29, 1977, showed that its revenues, Federal income tax expense and net operating income increased, along with the addition of plant facilities, over a period of 7 years (1970-1976 inclusive).

We believe the Commission's average annual adjustment method is a method to flow-through to the consumer in the form of lower rates a part of the reserve for deferred taxes. This does not appear to be what Congress intended by its enactment of section 167(*l*) of the Code. The General Explanation of the Tax Reform Act of 1969 prepared by the Staff of the Joint Committee on Internal Revenue Taxation states at 152 that the Act does not change the power of the regulatory agencies in the case of normalization to exclude the normalization reserve from the rate base upon which the agency computes the company's rate of return. Further, at 153 it states that the taxpayer is not treated as normalizing unless the entire deferral of taxes resulting from the difference between (a) the depreciation method used in the regulated books of account and (b) the accelerated depreciation method used on the return is normalized.

The use of accelerated depreciation along with the normalization method of accounting results in a tax deferral and not a tax forgiveness. Over the life of any given vintage property there is no tax savings. The excess of normalized tax allowance over the actual tax is charged to tax expense and credited to a reserve for deferred taxes. Subsequently, in later years when the actual tax expense exceeds the tax expense calculated under the straight line method, the excess of the actual tax over the normalized tax is credited to the actual tax expense, thus increasing income subject to tax. The reserve for deferred taxes will be written off by equivalent debits.

Accordingly, based on the facts as submitted, we believe that the Commission's annual average adjustment method is not a proper normalization method of accounting as defined under section 1.167(*l*)-1(h)(i) of the regulations. Therefore, should the Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability, but would be required to use a straight line method of depreciation.

Should the Commission amend its Decision No. X to eliminate the simple averaging of the test year and the succeeding three years to compute the reserve for deferred taxes, we believe it would then have to use either the estimated reserve for deferred taxes in conjunction with the estimated tax expense used for the purpose of establishing cost of service for ratemaking purposes, or it would have to use the actual reserve for deferred taxes in conjunction with the actual tax expense used for the purpose of establishing cost of service for ratemaking purposes. A larger reserve deducted from the rate base without consistency in computing tax expense would not be considered to be a proper normalization method of accounting and would be in excess of the amount permitted by the regulations. Therefore, the taxpayer would no longer be eligible to use an accelerated method of depreciation to compute its Federal income tax liability but would be required to use the straight line method of depreciation.

Should the Commission's Decision No. X become final, we further believe that the amount of the reserve for deferred taxes that includes the amount based on the CL system property and that is deducted from the rate base would be in excess of the amount that is permissible under section 1.167(*l*)-1(h)(6) of the regulations. Therefore, the taxpayer would not be considered to be using a proper normalization method of accounting. The failure to follow properly the normalized method of accounting will result in the termination of the election of the CL system at the beginning of the taxable year for which taxpayer fails to normalize properly such tax deferral. Additionally, the imputed flow-through of the 1969 vintage plant additions will not affect the taxpayer's eligibility with respect to the use of the CL

system for its pre-1971 public utility property so long as it complies with the requirements of section 1.167(a)-12(a)(4)(iii).

Very truly yours,

/s/ Geoffrey J. Taylor
Geoffrey J. Taylor
Chief,
Engineering and Valuation Branch

APPENDIX E

APPENDIX E

INTERNAL REVENUE SERVICE — DEPARTMENT OF THE TREASURY

Index Number: 0046.01-00 — Washington, D.C. 20224

Date: July 27, 1978

Mr. Robert Dalenberg
Vice-President & General Counsel
Pacific Telephone & Telegraph Company
140 New Montgomery Street
San Francisco, California 94105

Taxpayer—Pacific Telephone & Telegraph Co.

State—California

Commission—California Public Utility Commission

Parent—American Telephone & Telegraph Co.

Representative—Caplin & Drysdale

Decision No. X.—87838, September 13, 1977

[*Mr. A. M. Hart*
General Telephone Company of California
100 Wilshire Boulevard
Santa Monica, California 90401

Date: Aug. 9, 1978

Taxpayer	*General Telephone Company of California*
Commission	*California Public Utility Commission*
State	*California*
Parent	*General Telephone & Electronics Corp.*
Representatives	*Covington & Burling*
Decision X	*87838 - September 13, 1977*]*

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* Where the language of the ruling applicable to General differs from that of the ruling applicable to Pacific, the differing language in General's ruling is printed in italics in this Appendix.

Dear Mr. Dalenberg [*Mr. Hart*]:

This letter supplements ours of June 8, 1978, [*June 9, 1978*] in which we responded to your ruling request dated September 29, 1977, as supplemented, and filed on your behalf by the representative of your company.

You requested a ruling whether your company (the taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(l) of the Internal Revenue Code of 1954; (2) depreciation based on Class Lives Asset Depreciation Range (CLADR) system for post-1970 public utility property; (3) depreciation based on the Class Life (CL) system for pre-1971 public utility property (1968 and 1969 vintage accounts); and (4) the investment tax credit should Decision No. X of the Commission become final.

[*You requested a ruling whether your company (taxpayer) will remain eligible for: (1) accelerated depreciation under section 167(l) of the Internal Revenue Code; (2) the Class Life (CL) system with respect to the pre-1971 public utility property (1969 vintage accounts) under section 1.167(a)-12(a)(4)(iii) of the Income Tax Regulations; and (3) the investment tax credit should Decision No. X of the Commission, dated September 13, 1977, become final.*]

By letter dated December 22, 1977, [*January 24, 1978*] you formally requested that the issues be separated and the first three issues answered first and the investment tax credit issue responded to at a later date. The reason for this was that there were final regulations covering section 167(l) of the Code but there were no final regulations for section 46(f). Based on your request, we replied to the first three issues in our ruling letter of June 8, 1978, [*June 9, 1978*] and are now replying to the investment tax credit issue in this letter.

There are no final regulations covering your investment credit issue under section 46(f) of the Internal Revenue Code of 1954. However, Rev. Proc. 72-3, 1972-1 C.B. 698, sets out the conditions under which consideration will be given to the issuance of rulings in advance of the adoption of final regulations. This procedure provides in part that if an inquiry presents an issue on which the answer seems to be clear from the application of the provisions of the statute to the facts described, a ruling will be issued in accordance with specific procedures. This is considered to be such a ruling.

Finding 3 of the Commission's Decision No. X provides for a method of normalizing the tax deferral resulting from the difference between computing Federal income taxes using straight line depreciation expense used for ratemaking purposes and accelerated depreciation expense used for actual Federal income taxes. Our letter of June 8, 1978 [*June 9, 1978*], dealt with this finding.

Finding 4 of the Commission's Decision No. X provides that the Commission shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of investment tax credit estimated for the next immediate future calendar year as compared to the last year (or last preceding year), and recomputing Federal income tax expense and gross revenue requirements based on that new estimate for each year between rate cases. The Commission contends that this method complies with the requirements of ratable (service life) flow-through selected by the utility under section 46(f)(2) of the Code.

Finding 5 of the Commission's Decision No. X provides that the methods described in Findings 3 and 4 are an attempt to more accurately reflect in rates the abnormal growth in depreciation and investment credit tax reserves compared to the other components of cost of service used in computing rates.

Finding 6 of the Commission's Decision No. X provides that the methods adopted in Decision No. X, as described in Findings 3 and 4, comply with the mandate of the California Supreme Court as set forth in *City of Los Angeles v. Public Utilities Commission* (1975) 15 C 3d 680.

Pacific [*General*] has made a timely election to be governed by section 46(f)(2) of the Code in its accounting treatment of the investment tax credit for ratemaking purposes. Therefore, it is of vital concern to Pacific [*General*] to know whether the specific ratemaking treatment ordered by Decision No. X is consistent with the requirements of section 46(f)(2) of the Code in order that the investment tax credit not be disallowed should Decision No. X become final.

You have explained that [*As we understand*] the ratemaking treatment of investment credit contained in the Commission's Decision No. X involve the following steps [*the following steps are involved*] for each of the test years and subsequent years until the next rate case involving a new test year.

First, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test year. The depreciation expense in cost of service included depreciation on the investment in the property that had generated the credit (without any reduction in the basis of the property by any portion of the credit) and the rate base also included such property investment (unreduced by the credit).

Second, at the beginning of the year following the test year, the credit produced by additional investment in property for that coming year was determined. (In the case of future years, these amounts were estimated.) Cost of service as determined for the test year was then further reduced by a ratable amount of such credit; the net revenue requirement for the year following the test year was reduced dollar-for-dollar by that further reduction in cost of service; and rates were reduced for such following year on the basis of the reduction in gross revenue requirement determined by multiplying the net revenue requirement reduction by a net to gross multiplier.

Third, the process described in the second step was repeated for each succeeding year until the next rate case, which involved a new test year.

As explained further, [*Further, we understand that*] the significant features of these three steps from the standpoint of section 46(f)(2) of the Code are the differences between the treatment of the credit for the test year in the first step and the treatment of the credit in the second and third steps for years following the test year. In the first step, the only credit that was used to reduce cost of service was a ratable portion of the credit resulting from property investment that had been included (unreduced by the credit) both in rate base and in the basis from which the depreciation expense in cost of service was determined. Therefore, rate base was not reduced within the meaning of section 46(f)(2)(B) by any portion of the allowable credit that was used to reduce cost of service under section 46(f)(2)(A). Also, cost of service was reduced under section 46(f)(2)(A) only by a ratable portion of the credit. Cost of service was not reduced further by reduced depreciation expense since the depreciation basis included the total investment in the property (unreduced by the credit) that generated such credit.

By contrast, in the second and third steps, you have explained [*we understand*] that rates were recomputed for each coming year by the lone adjustment resulting from including a ratable portion of the coming year's credit in the reduction of cost of service. Although your net investment and depreciation expense thereon were increasing in each year affected by Decision No. X, no adjustment to rates was

made to reflect the net increase in rate base, or the net increase to the basis used to determine depreciation expense, due to the investment in the qualified property that gave rise to the credit. This net increase in investment was totally excluded in determining rate base and depreciation expense in each year following the test year. Therefore, you contend that there was, in effect, a further reduction in rates through a reduction to rate base by reason of the credit and a reduction to depreciation expense (as well as a reduction of tax expense by reason of the credit) in each such year.

Pacific [*General*] is concerned that the treatment of the credit for the years following the test years in the second and third steps does not conform to the requirements of either subparagraph (A) or subparagraph (B) of section 46(f)(2) of the Code. This concern arises because subparagraph (A) can be interpreted to mean that cost of service has been reduced by more than a ratable portion of the credit if, in addition to the reduction to cost of service by a ratable portion of the credit, depreciation expense has also been reduced because the property investment which produced the credit has not been used to reflect a net increase in the basis used to determine depreciation expense. Additionally, Pacific [*General*] is concerned because subparagraph (B) can be interpreted to mean that there has been a reduction to rate base by reason of the credit if the qualified property, which generated the credit used to determine the ratable reduction in cost of service under subparagraph (A), is not included in rate base to the extent such property represents a net increase in rate base.

Section 46(f)(2) of the Code provides that if the taxpayer makes an election under this paragraph within 90 days after the date of the enactments of this paragraph in the manner prescribed by the Secretary, section 46(f)(1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property of the taxpayer—

(A) —If the taxpayer's cost of service, for ratemaking purposes or in its regulated book of account, is reduced by more than a ratable portion of the credit allowable by section 38, or

(B) —If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38.

Section 46(f)(6) of the Code provides that for purposes of determining ratable restorations to rate base under section 46(f)(1) and for purposes of determining ratable portions under section 46(f)(2)(A), the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

Section 12.3(a) of the Temporary Income Tax Regulations provides that a public utility may make one of two elections under section 46(f) of the Code (section 46 (f)(1) or (2)) with respect to the method of accounting for the investment credit for public utility property for ratemaking purposes. A public utility with public utility property to which section 167(1)(2)(C) applies has an additional option of a third election, section 46(f)(3). If an election under section 46(f)(1), (2), or (3) is made, it is irrevocable. If no election is made, section 46(f)(1) applies as if the taxpayer had elected to have the provisions of section 46(f)(1) apply.

The language of section 46(f)(2) of the Code demonstrates the integrated nature of the conditions set forth in subparagraphs (A) and (B) that will result in the disallowance of the credit if not avoided. In each subparagraph, the term "credit allowable" is used to describe that which may not be used to reduce cost of service faster than ratably as well as that which may not be used to reduce rate base in any manner. Thus, subparagraph (B), in prohibiting a

reduction in rate base "by reason of any portion of the credit allowable," and subparagraph (A), in limiting the reduction in cost of service to not more than "a ratable portion of the credit allowable," indicate that any credit, a ratable portion of which is used to reduce cost of service, must be included in rate base in order that there be no reduction in rate base as is required by subparagraph (B).

Additionally, the following House and Senate Committee Reports clarify that compliance with both subparagraphs (A) and (B) of section 46(f)(2) of the Code is to be determined by reference to "any accounting treatment" that can effect a reduction in cost of service or a reduction in rate base.

The language of the Committee Reports is as follows:

> In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service. One usual method of flowing through the investment credit is to reduce the amount of Federal income tax taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.
>
> In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment. . . . H.R. Rep. No. 92-533, 92nd Cong., 1st Sess., at 26 (1971); S. Rep. No. 92-437, 92d Cong., 1st Sess., at 39 (1971).

With respect to the reduction in cost of service governed by section 46(f)(2)(A) of the Code, the above Committee Reports note at least two methods by which cost of service can be reduced for ratemaking purposes: (1) the usual method of reducing the Federal income tax element in cost

of service, and (2) an alternative method of reducing the depreciation expense element in cost of service by not including the investment credit in depreciable basis. It follows, therefore, that the use of more than one method to reduce cost of service would cause an aggregate reduction that could exceed the "ratable portion of the credit allowable" that is permitted under section 46(f)(2)(A).

Under the facts you have presented and our understanding of he ratemaking treatment of the investment tax credit prescribed in the Commission's Decision No. X for the years subsequent to the test year, there could be, in effect, a reduction in Pacific's [*General's*] cost of service for ratemaking purposes by more than a ratable portion of the credit and a reduction in its rate base by reason of a portion or all of the credit.

For the test year, under Decision No. X, tax expense in cost of service was reduced by ratable amounts of the aggregate investment credit that had been allowed for the years up through the test-year. Such treatment would be consistent with the requirements of section 46(f)(2)(A) of the Code to avoid disallowance of the credit. The rate base included the qualified property investment (unreduced by the credit) that had generated the credit. Also, the depreciation expense in cost of service included depreciation on the qualified property investment (which had generated the credit) without any reduction in the depreciation basis of the property by any portion of the credit. Such treatment would be consistent with the requirement of section 46(f)(2)(B) that the rate base not be reduced by any portion of the credit allowable.

For the annual adjustment of rates after the test year, the application of Decision No. X requires an annual recalculation of the ratable portion of the investment tax credit (for reduction of the cost of service) to reflect anticipated investments in new property. There is no indication that this annual adjustment of rates (to reduce cost of service by a ratable portion of the credit allowable on anticipated

new investments) also includes an adjustment to rate base, depreciation expense, or other cost of service factors to reflect the resulting net increase of anticipated new investments over retirements from the rate base and depreciation base.

By not including an adjustment to rate base to reflect the net increase as a result of the anticipated new investments, the rate base will have been effectively reduced by reason of the credit generated by such new investments. Therefore, the failure to adjust the rate base to reflect the net increase as a result of the anticipated new investments would be in violation of section 46(f)(2)(B) of the Code because the rate base would be reduced by reason of the credit generated by the new investments. Further, by using an accounting treatment that does not include an adjustment to depreciation expense to reflect the net increase in the depreciation base from anticipated new investments that generated a credit, the cost of service would be considered to have been further reduced by reason of the credit, in violation of section 46(f)(2)(A) and the intent of Congress expressed in the Committee Reports.

Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4), we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) of the Code and would result in Pacific's [*General's*] loss of eligibility for the investment tax credit under section 38.

Yours very truly,

/s/ John W. Holt
Director, Corporation Tax
Division